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Ministers to Review Global Economic Prospects at Spring Meetings

Prospects and policies for strong noninflationary growth in industrial and developing countries will be a key item on the agenda during the IMF-World Bank Spring Meetings which are to be held April 26–May 1 in Washington. At their April 30 meeting, members of the IMF's Interim Committee of the Board of Governors on the International Monetary System will also discuss economic stabilization and transformation in the former socialist economies. In addition, IMF Managing Director Michel Camdessus will report to the Interim Committee on adjustment and financing in low-income countries—including the IMF's role; ways to further strengthen IMF surveillance of the global monetary system; and the question of allocations of SDRs.

Interim Committee Chairman Carlos Solchaga

Development Committee Chairman Ricardo Hausmann

The Development Committee (Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries) will meet on May 1. The main item for discussion will be developing country access to private capital flows. The committee will also consider progress in regard to private sector development and the outcome of negotiations on the tenth replenishment of the International Development Association (the World Bank's soft-loan affiliate).

The meetings of the Interim and Development Committees will be preceded by ministerial meetings of the Group of 10, the Group of 24, and the Group of 24 Deputies.

On April 26 (before the ministerial meetings), Michael Mussa, Economic Counsellor and Director of the IMF's Research Department, will brief the press on the 1993 *World Economic Outlook*.

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NATIONAL ECONOMIES

China's Open Economic Zones Are Speeding Its Transformation to a Market Economy

One of the key aspects of China's reform efforts, initiated in 1978, has been the opening of its economy to promote modernization by using foreign capital and technology and by stimulating exports. A critical element of the Government's strategy to achieve these goals has been to designate a number of clearly defined areas as "open economic zones" in which outward-oriented activity will be promoted through foreign direct investment and trade.

In the following article, Michael Bell and Simon N'guiamba of the IMF Central Asia Department describe the various forms of open economic zones in China, their performance, and their impact on the Chinese economy in recent years.

The policy to open up China's economy has been implemented in four stages. The first stage involved the establishment of four Special Economic Zones (SEZs) in 1979–80. The SEZs were to be more ambitious in terms of policies, activities, and geographical coverage than traditional export-processing zones. They were to promote production for export and facilitate imports of advanced technology. In due course they came to serve as "laboratories" for experimenting with market-oriented reforms. Enterprises operating in the SEZs were offered preferential treatment in terms of taxation, import licensing, and tariffs.

During the second stage, which began in 1984, these policies were extended to other areas: 14 coastal cities were authorized to establish "open zones" within their jurisdictions. The third stage involved the establishment of Hainan island as an SEZ in 1988 and the opening of the most ambitious of the economic development zones — Pudong New Area (in Shanghai)—in 1990. In the last stage, which followed senior leader Deng Xiaoping's initiative in early 1992 to accelerate economic reforms, preferential policies were extended to cities in inland provinces—particularly those along the Yangtze River valley—and a number of cities mainly on China's northeastern borders.

A view of Shenzhen, the site of one of the four original Special Economic Zones.

Special Economic Zones

The Original SEZs. Ease of access to foreign markets was the basis for choosing the locations for the four original SEZs, which remained the only open economic zones in China through 1984. Three of the four are in Guangdong province: Shenzhen (near Hong Kong); Zhuhai (near Macao); and Shantou in the southeastern coastal area of the province. The fourth is located in Xiamen in the southeastern part of Fujian province.

An important difference between the SEZs and other areas of China is that investment decisions taken in the SEZs are largely outside the State Plan. Local authorities in SEZs are allowed to offer preferential policies to foreign investors, to develop their own infrastructure, and to undertake other investments, provided they can raise the funds. Enterprises in the zones may also make their own investment, production, and marketing decisions. This relative autonomy has been an important factor in attracting investment into the SEZs—both from other areas of China and from abroad.

Enterprises operating in the zones comprise:

- state enterprises, including those owned by local authorities or by authorities of other provinces; and
- foreign-funded enterprises (FFEs), including wholly owned enterprises,

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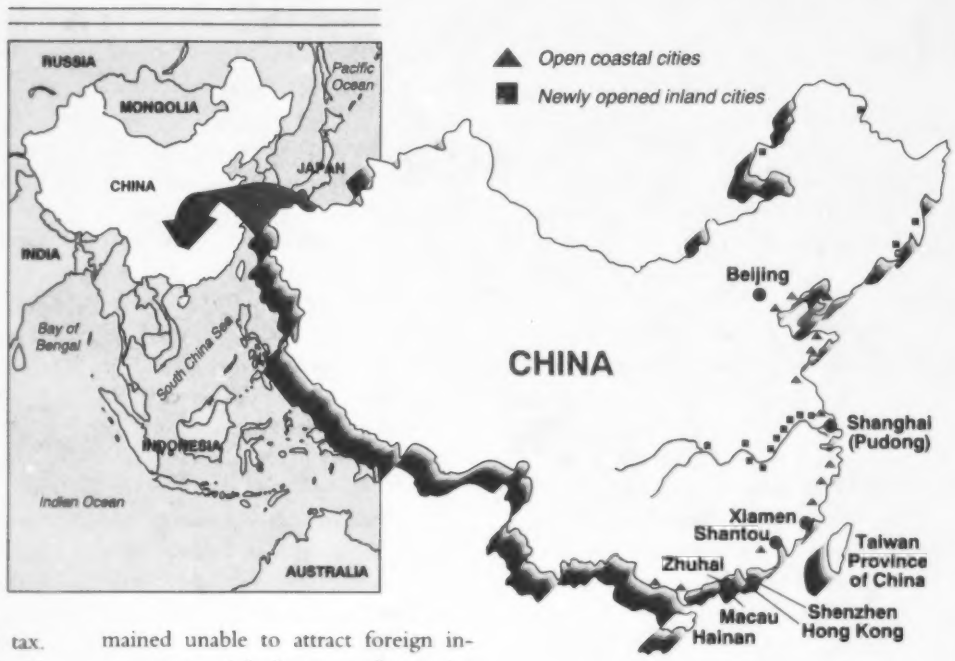
equity joint ventures, and contractual joint ventures (enterprises managed by foreign partners under contract).

FFEs operating in the zones generally make their own decisions with respect to their organizational and personnel structures, wage systems, and the hiring and firing of employees. With the authorities' approval, they may sell part of their output in the domestic market.

FFEs enjoy a tax holiday for the first two years. During the next three years, they pay 7.5 percent tax on their profits. Subsequently, they (as well as domestic enterprises in the SEZs) are subject to 15 percent tax. The tax rate outside the SEZs is 33 percent for FFEs and 55 percent for domestic enterprises.

During 1980–85, starting from a very low base, the four original SEZs attracted substantial foreign direct investment to develop their basic infrastructure and to initiate industrial production. In 1985, for instance, they accounted for more than one-third of all actual and planned equity joint ventures in China. Their performance was also impressive in subsequent years in terms of exports, foreign direct investment inflows, and industrial output: between 1987 and 1991, the value of their exports more than doubled to $9.6 billion (about 13 percent of China's total); their contracted foreign investment increased eightfold; and their industrial production rose by more than 35 percent in 1991 alone. Provisional data for 1992 indicate substantial further increases in activity.

Hainan. Hainan island, which was one of the poorest regions of China through the mid-1980s, was designated a "special area open to foreign investment" in 1983. However, it remained unable to attract foreign investment mainly because of poor infrastructure. But as labor costs rose in Guangdong, Hainan—with its abundant cheap labor—developed into an attractive site for foreign investment in labor-intensive activities.



In 1988, Hainan was designated China's largest SEZ and began to focus more on export promotion and on attracting foreign investment. Its preferential policies are more generous than those of the other SEZs. For example, it is one of the few areas where foreign exchange earned through merchandise exports and other business transactions can be retained in cash, regardless of ownership. Among its other advantages are low land prices and policies that permit free movement of goods and capital.

Hainan is experimenting with a market-oriented system of economic management. One aspect is that trading in land-use rights is permitted: the authorities can lease land owned by the state for up to 70 years, and domestic and foreign investors are allowed to engage in land development. Its authorities are empowered to approve projects whose total investment is less than $30 million. They may also issue bonds with the approval of the State Council.

During 1988–91, Hainan's economic development accelerated. It attracted substantial financial inflows from other provinces and from abroad, its exports more than doubled, and its per capita income caught up with the rest of China. By the end of 1991, it had approved the establishment of more than two thousand foreign-funded enterprises with a total value of contracted foreign investment amounting to $394 million.

Open Coastal Cities

Encouraged by the success of the original four SEZs, the Chinese Government decided, in April 1984, to open 14 larger, established coastal cities to foreign trade and investment. At the time they were chosen, these cities were relatively well developed in terms of industry, infrastructure, and technical and managerial expertise.

The authorities of the 14 coastal cities can approve construction and industrial projects involving foreign investment that does not exceed $5 million ($10 million for Dalian and $30 million for Tianjin and Shanghai). Nonmanufacturing projects involving foreign investment are not subject to upper limits but must be financed mainly by foreign resources.

The coastal cities offer foreign investors most of the preferential policies prevailing in the SEZs. The main difference relates to the corporate income tax, which is generally 24 percent in the cities, although some types of projects are eligible for lower rates.

Certain areas within most of the 14 open coastal cities have been designated Economic and Technical Development Zones (ETDZs). These zones are often located near the harbor and are designed to provide basic infrastructure for the establishment of new enterprises. The ETDZs enjoy the same tax concessions as those offered in Special Economic Zones; these concessions are limited in other parts of the coastal cities.

The economic performance of the 14 coastal cities has varied. Although industrial growth in 8 of them was higher than the national average during 1984–90, that in all the cities taken as a group was well below the national average. The dollar value of the cities' exports (excluding exports from ETDZs) rose by 10 percent in 1991 and by about 15 percent in 1992—close to the national average. The value of foreign direct investment contracted by the 14 cities increased by nearly 35 percent in 1991 (compared with the previous year) and then threefold in 1992.

The apparent contrast between the slow industrial growth and the rapid export expansion in the 14 open coastal cities reflects their initial relatively low level of exports and the obsolescence of many of their long-established industries. It also indicates that the preferential terms offered in ETDZs have been more effective in increasing exports than in expanding industrial capacity.

Photo Credits: Denio Zara and Padraic Hughes for IMF; pages 113, 123, and 125. Shenzhen Investment Guide, page 114; Pudong Development Office of Shanghai, page 117.

Pudong New Area

China's policy of encouraging economic openness progressed further in April 1990, when the Pudong New Area of Shanghai was selected to become an open economic zone that would enjoy policies more flexible than those already in force in the four original SEZs. The Pudong New Area was expected to lead the opening up of the Yangtze River valley and to be the focal point of China's development during the 1990s. The authorities envisaged that, in the process, Shanghai would become a major economic, trading, and financial center for China—and indeed, for all of Asia.

Pudong's development aims at establishing a finance and trade zone, an export-processing zone, a free trade zone, and a high-technology park. Pudong differs from the original SEZs in that its preferential policies are broader in scope. Notably,

- foreign business is allowed to engage in retail sales;
- foreign-owned enterprises can trade their foreign exchange freely;
- foreign insurance companies may be established;
- foreign enterprises can build and operate port facilities;
- approved enterprises can engage in foreign trade without restrictions within a certain subzone; and
- foreigners can trade on a recently established securities market.

Pudong has enjoyed early success. Its output growth, led by manufacturing and services, was about 14 percent in 1991 (compared with 7.7 percent for China as a whole). Moreover, despite its infancy as an open economic zone, Pudong has attracted substantial investment, both foreign and domestic. Between 1990 and 1992, its authorities approved the establishment of 704 foreign-funded projects—most of them in high-technology activities—involving investment totaling more than $3 billion. In addition, 11 foreign banks have already opened branches in Pudong, and more than thirty others have applied to do so.

Domestic investment is also on the rise. By the end of 1992, China's central, provincial, and municipal governments had set up more than one thousand enterprises in Pudong, involving investment commitments of about $1.5 billion. Capital market activity also expanded dramatically in 1990–92. For example, the value of securities traded in Shanghai soared from about $500 million in 1990 to about $12.3 billion in 1992.

Inland Provinces

The level of foreign investment in inland provinces was relatively low from 1978 through 1991. Concentrated, for the most past, on resource-based ventures, it was confined largely to a few areas—mainly around Beijing and a number of cities in the provinces of Shaanxi and Sichuan.

Although the foreign trade of inland provinces developed faster than foreign direct investment, it still lagged far behind that of the coastal provinces. In 1990, exports from the inland provinces represented about 28 percent of the national total and their imports only 10 percent. The

The Pudong World Plaza (Shanghai) was constructed with foreign investment capital.

total trade of the inland provinces was 12 percent of GNP in 1990, compared with close to 40 percent for the coastal provinces.

An important reason for the relatively low level of foreign direct investment in inland provinces was the absence of preferential policies. Foreign investment was further discouraged by the limited power of local governments to approve investment projects, poor infrastructure, and the lack of technical and managerial expertise and skilled labor.

In 1992, the central authorities decided to apply preferential policies to 23 major cities in inland provinces, including 18 provincial capitals and 5 cities along the Yangtze River valley. In addition, 6 "development zones" were set up in the same region. The Government also permitted cities bordering neighboring countries to open their economies to the outside world. Meanwhile, many provinces have been trying to open up more cities.

Most of the tax incentives offered in the original SEZs, Hainan, and Pudong are to be applied in the newly opened cities of inland provinces. In addition, many provinces have transferred powers to local authorities to approve foreign investment projects in their respective areas. Some areas have, in fact, offered even more generous terms than those applied in the SEZs and Pudong without approval from the central govenment. These include a five-year tax exemption and a 50 percent reduction of corporate income tax over the subsequent five years.

Conclusions

China's moves to open its economy to the rest of the world over the past 13 years have helped increase its access to foreign capital, trade, and advanced technology, thus contributing significantly to the country's rapid economic development. The acceleration of the "opening-up" policy in 1992 has paid further dividends. In that year, the value of China's exports increased by over 18 percent to $85 billion, with manufactured goods accounting for 80 percent of the total. The exports of FFEs grew by about 44 percent to $17.4 billion, and their share in total exports rose to about 20 percent in 1992 (from 17 percent in 1991). China attracted commitments of foreign direct investment valued at $57.5 billion, and the amount of foreign direct investment that actually came in was $11.2 billion—an increase of 160 percent over 1991. Reflecting these developments, the number of FFEs operating in China rose to about eighty-four thousand at the end of 1992, from about thirty-seven thousand a year earlier.

Despite their positive impact, China's open economic zones raise questions. On the domestic front, the intense competition among the various provinces—with each trying to offer more generous policies to investors than the others—could have an adverse impact on government revenue. Moreover, the proliferation of development zones could divert land away from agricultural use, a critical issue given the scarcity of arable land. Partly in response to such concerns, the Government has announced that the opening of development zones will be slowed.

On the external front, China's ongoing negotiations on resuming its participation in the General Agreement on Tariffs and Trade may make it necessary for the authorities to review the policy of offering preferential terms to new investors in open economic zones.

Whatever the future of China's open economic zones, there can be little doubt that they have played an important role in the country's transformation to a market economy. They have achieved far more than their initial aims of attracting foreign investment and technology and of earning foreign exchange to pay for imports to modernize the economy. Their use as laboratories for experimenting with market-oriented policies and their spread, in various forms, have established them as "nodes of development" that are affecting increasingly large areas of the country.

As the Chinese economy becomes more market oriented and open, the time will come for a careful review of the role of such zones. The key question that might then arise is whether China's long-term development might not be best served by phasing out those special arrangements that should be regarded as transitional (such as certain tax concessions), while extending others to all areas of the country.

IMF ACTIVITIES

From the Executive Board . . .

Philippines: Stand-By Credit. The IMF has approved a request by the Philippines to augment its current stand-by credit by SDR 70 million (about $97 million) for interest support in connection with debt and debt-service reduction implemented by the Philippines and its commercial bank creditors in December 1992.

The IMF approved a stand-by credit of SDR 264.2 million (about $367 million) for the Philippines in February 1991 to support the Government's economic and financial program. To date the IMF has disbursed SDR 207.6 million (about $288 million), including SDR 51.9 million (about $72 million) of set-asides to support debt-reduction operations. With the augmentation, a total of SDR 126.6 million (about $175 million) is available immediately to the Philippines under the stand-by credit.

The commercial bank debt deal was a voluntary and market-based transaction that is expected to result in significant financial savings for the Philippines. Its completion has also enabled the country to regain access to the international capital market with a successful Eurobond issue in February 1993.

Building on the successes achieved in 1991, further advances were made in the Philippine economy during 1992. The rate of inflation

Currency Units per SDR

Currency	MARCH 9	10	11	12	15	16	17	18	19	22
Deutsche mark	2.28537	2.28538	2.28953	2.28231	2.28536	2.28221	2.28781	2.29163	2.28894	2.28948
French franc	7.73875	7.75875	7.76747	7.76643	7.76497	7.76703	7.77437	7.77571	7.74598	7.74802
Japanese yen	160.705	161.498	161.874	161.503	162.261	162.24	160.88	161.066	160.898	161.093
Pound sterling	0.954161	0.957238	0.958161	0.958078	0.956885	0.95162	0.948907	0.943631	0.930469	0.933867
U.S. dollar	1.3759	1.37153	1.37085	1.37216	1.37045	1.37433	1.37563	1.37487	1.38705	1.38754
Argentine peso	...	...	...	...	...	...	...	...	...	...
Australian dollar	1.95802	1.95152	1.94198	1.94633	1.93922	1.94554	1.94828	1.9378	1.93614	1.93547
Austrian schilling	16.0788	16.073	16.1092	16.0556	16.0713	16.0577	16.0949	16.13	16.0038	15.9747
Bahrain dinar	0.517338	0.515695	0.515364	0.515932	0.515289	0.516748	0.517237	0.516951	0.521531	0.521715
Bangladesh taka	53.6801	53.4897	53.4554	53.5142	53.4476	53.5989	53.6496	53.6199	54.095	54.1141
Belgian franc	47.0627	47.0058	47.1436	46.9896	47.0475	46.9677	47.0362	47.1237	46.9308	46.7601
Brazilian cruzeiro	29033.4	29233.2	29509.4	29637.8	30099.1	30486.5	30820.9	31113.2	31704.	32035.4
Canadian dollar	1.71451	1.70693	1.70591	1.70801	1.70813	1.71819	1.72174	1.71405	1.72771	1.72776
Colombian peso	1143.52	1140.4	1140.16	1141.95	1141.04	1144.87	1146.55	1146.49	1157.1	1158.08
Danish krone	8.76861	8.76065	8.78107	8.76399	8.78116	8.78059	8.77858	8.79845	8.76546	8.73595
Finnish markka	8.29337	8.28802	8.30353	8.28771	8.30685	8.29381	8.24952	8.28373	8.26099	8.22326
Greek drachma	...	308.293	309.472	308.722	309.174	309.527	309.929	310.947	309.756	308.769
Indian rupee	43.217	43.3403	43.3537	43.3603	43.1007	43.2914	43.2911	43.2397	43.6227	43.6243
Indonesian rupiah	2845.36	2837.7	2835.87	2839.	2836.83	2846.24	2847.55	2845.98	2869.81	2872.21
Iranian rial	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3
Iraqi dinar	0.427709	0.42635	0.426077	0.426546	0.426014	0.427221	0.427625	0.427388	0.431175	0.431327
Irish pound	0.937837	0.939726	0.940283	0.94048	0.940145	0.93997	...	0.940468	0.936626	0.937527
Italian lira	2203.32	2210.62	2208.97	2207.76	2203.67	2208.82	2207.36	2210.05	2197.56	2201.22
Korean won	1090.81	...	1085.69	1088.81	1087.73	1088.74	1089.91	1090.13	...	1100.18
Kuwaiti dinar	0.419705	0.416372	0.418377	...	0.417948	0.419129	0.418852	0.41862	...	0.420355
Libyan dinar	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286
Malaysian ringgit	3.60142	3.58312	3.57356	3.57626	3.56728	3.57296	3.57114	3.5726	3.60175	3.60691
Maltese lira	0.528647	0.527999	0.528739	0.528913	0.52907	0.528853	0.52915	0.529081	...	0.529131
Nepalese rupee	69.0564	68.8371	68.7792	68.8275	68.7418	68.9364	69.0016	68.9635	69.5606	69.5851
Netherlands guilder	2.56523	2.56915	2.57189	2.56855	2.56768	2.56794	2.57119	2.56551	2.55037	2.55502
New Zealand dollar	2.61032	2.60351	2.6053	2.60323	2.60196	2.60784	2.59504	...	...	2.59305
Norwegian krone	9.71317	9.71455	9.7275	9.71489	9.71786	9.70758	9.71951	9.73339	9.68924	9.64757
Omani rial	0.529034	0.527353	0.527015	0.527596	0.526936	0.52843	0.52893	0.528638	0.533321	0.533509
Pakistan rupee	36.456	36.3402	36.4131	36.4532	36.5451	36.6486	36.7523	36.732	37.0574	37.0705
Portuguese escudo	210.694	211.05	211.693	211.244	211.31	211.041	211.378	211.428	210.945	210.624
Qatar riyal	5.00828	4.99237	4.98917	4.99466	4.98844	5.00256	5.00729	5.00453	5.04886	5.05065
Saudi Arabian riyal	5.15275	5.13638	5.13308	5.13874	5.13234	5.14687	5.15173	5.14869	5.1945	5.19634
Singapore dollar	2.26514	2.25905	2.25993	2.25981	2.25741	2.26036	2.26525	2.26249	2.27637	2.27945
South African rand	4.37467	4.37175	4.37717	4.38189	4.38338	4.39167	4.39995	4.38652	4.40804	4.4096
Spanish peseta	162.7	162.773	162.984	163.04	163.029	163.147	163.384	163.321	...	162.606
Sri Lanka rupee	64.3921	64.2636	64.352	64.4915	64.5071	64.7309	64.8197	64.8251	65.4271	65.4225
Swedish krona	10.4789	10.4325	10.6294	10.6768	10.7676	10.8022	10.6419	10.735	...	10.6917
Swiss franc	2.11336	2.11078	2.10573	2.09117	2.09473	2.08994	2.09467	2.11043	2.09167	2.09519
Thai baht	34.9616	34.9192	34.9105	34.9215	34.9191	35.0042	34.9823	34.9629	35.2033	35.2158
Trinidad and Tobago dollar	5.86219	5.84358	5.83983	5.84628	5.83697	5.8555	5.86104	5.85781	5.9097	5.91179
U.A.E. dirham	5.05093	5.03485	5.03166	5.0372	5.03092	5.04517	5.04904	5.04715	5.09186	5.09366
Venezuelan bolivar	115.163	114.934	114.998	115.33	115.46	...	116.103	116.177	...	117.386

Notes: 1. The value of U.S. dollar in terms of the SDR is the reciprocal of the sum of the dollar values, based on market exchange rates, of specified quantities of the first five currencies shown. The exchange rates used for this purpose are noon rates in the London foreign exchange market. When the London market is closed, noon rates in the New York market are used. Frankfurt fixing rates are used when the New York market is closed. 2. The value in terms of the SDR of each of the other currencies shown above is derived from that currency's representative exchange rate against the U.S. dollar as reported by the issuing central bank and the SDR value of the U.S. dollar, except for the Iranian rial and the Libyan dinar, the values of which are officially expressed directly in terms of the domestic currency units per SDR.

Data: IMF Treasurer's Department

was reduced to 8 percent from 13 percent a year earlier, and the external current account position continued to show substantial improvement. Supporting these positive developments was a tight fiscal stance that resulted in a much lower public sector deficit. However, real GNP growth remained weak.

Together with the success achieved in macroeconomic stabilization, the Philippines made significant progress in implementing structural reforms. Steps were taken to reduce import tariffs and eliminate remaining quantitative import restrictions, and measures were introduced to liberalize the exchange system, virtually abolishing all restrictions on payments for current and capital transactions. In addition, the authorities are pressing forward with plans for a comprehensive restructuring of the Central Bank.

The Philippines is an original member of the IMF, and its quota is SDR 633.4 million (about $880 million). Its financial obligations to the IMF resulting from past operations and transactions currently total the equivalent of SDR 788 million (about $1,093 million).

Press Release No. 93/13, March 26

Burkina Faso: Enhanced Structural Adjustment Facility. The IMF has approved a three-year loan for Burkina Faso equivalent to SDR 48.62 million (about $67 million) under the enhanced structural adjustment facility (ESAF) to support its economic and financial program for 1993–95. Burkina Faso may draw up to SDR 17.68 million (about $25 million) under the first loan disbursement.

Burkina Faso began to reorient its economic policies in 1991, making considerable progress in the areas of macroeconomic and structural policies. To address the continuing economic problems, the authorities have adopted a medium-term program for 1993–95 aimed at achieving an average annual growth rate of real GDP of 3–4 percent; reducing the fiscal deficit from 6.1 percent of GDP in 1992 to 2.8 percent in 1995; limiting the rate of inflation to some 2½ percent a year; and lowering the current account deficit from 15.4 per-

Currency Units per SDR

Currency	MARCH 23	24	25	26	29	30	31	APRIL 1	2	5
Deutsche mark	2.26791	2.2655	2.26361	2.2686	2.25962	2.2609	2.25636	2.25852	2.24216	2.248
French franc	7.71682	7.70801	7.69904	7.71385	7.68708	7.66628	7.65802	7.66185	7.62237	7.62964
Japanese yen	160.317	160.89	161.983	161.974	161.709	162.01	162.626	160.193	160.456	160.04
Pound sterling	0.94036	0.937554	0.936909	0.929982	0.931084	0.930768	0.929651	0.926818	0.918021	0.925824
U.S. dollar	1.38883	1.38758	1.38447	1.38676	1.38806	1.38731	1.39773	1.38968	1.40751	1.40509
Argentine peso	...	...	...	...	...	...	...	...	...	...
Australian dollar	1.98328	1.98625	1.98267	1.95898	1.98109	1.94984	1.98035	1.99954	2.01505	2.01273
Austrian schilling	15.9401	15.9155	15.9422	...	15.8933	15.8847	15.8796	15.9144	15.7766	15.8171
Bahrain dinar	0.522125	0.52173	0.520561	0.521422	0.521911	0.521629	0.525546	0.52628	0.529224	0.528314
Bangladesh taka	54.1566	54.1158	53.9943	54.0836	54.1343	54.1051	54.5115	54.5875	54.8929	54.7985
Belgian franc	46.6267	46.6296	46.6636	46.9626	46.5633	46.4992	46.4605	46.8058	46.205	46.2907
Brazilian cruzeiro	32386.9	32694.4	...	33356.	33743.2	34094.9	34728.7	35160.	35812.7	36213.1
Canadian dollar	1.73267	1.72657	1.72214	1.72568	1.7298	1.73594	1.75723	1.76122	1.77487	1.77379
Colombian peso	...	1158.63	1156.61	1159.14	1160.77	1160.53	1169.82	1172.09	1179.34	1177.93
Danish krone	8.69491	8.68903	8.7007	8.74788	8.68509	8.66999	8.66103	8.69201	8.62874	8.63498
Finnish markka	8.2025	8.17021	8.19177	8.25891	8.19636	8.19096	8.20821	8.21402	8.15821	8.17214
Greek drachma	308.29	307.751	...	310.017	307.83	307.927	308.269	309.378	306.809	307.153
Indian rupee	43.7002	...	...	43.5859	43.3075	43.2979	43.6511	43.712	44.0269	...
Indonesian rupiah	2874.46	2872.29	2865.85	2870.59	2874.67	2873.12	2884.7	2897.34	2912.14	2907.13
Iranian rial	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3
Iraqi dinar	0.431666	0.431339	0.430373	0.431084	0.431489	0.431255	0.434495	0.435101	0.437535	0.436783
Irish pound	0.934916	0.932701	0.931676	0.933342	0.930335	0.929272	0.92743	0.927678	0.922232	0.923915
Italian lira	2196.17	2197.68	2215.97	2213.34	2235.96	2248.98	2233.89	2244.23	2242.71	2233.81
Korean won	1101.46	1100.49	1098.02	1100.12	1101.15	1101.25	1109.8	1111.35	1119.25	1117.89
Kuwaiti dinar	...	...	...	...	0.420513	0.421673	0.422883	0.422437	...	0.423255
Libyan dinar	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286
Malaysian ringgit	3.60794	3.60674	...	...	3.6041	3.59591	3.62641	3.62979	3.64827	3.63989
Maltese lira	0.527455	0.526057	0.525635	...	...	0.524741	...	0.525327	0.522015	0.524522
Nepalese rupee	69.6398	69.5733	69.4173	69.5044	69.4446	69.2961	69.7188	69.816	70.0799	69.9594
Netherlands guilder	2.55286	2.54482	2.54576	2.55011	2.54029	2.54072	2.53758	2.53916	2.5224	2.52663
New Zealand dollar	2.60336	...	2.60337	2.60083	2.60424	2.59504	2.61747	2.6414	2.65969	2.64313
Norwegian krone	9.62043	9.61315	9.63453	9.67958	9.6144	9.60712	9.60171	9.6291	9.55207	9.56375
Omani rial	0.533628	0.533525	0.532329	0.533209	0.533709	0.533421	0.537427	0.538177	0.541188	0.540257
Pakistan rupee	37.0996	37.0716	36.9865	37.0497	37.0844	37.0643	37.3427	37.3948	37.604	37.5394
Portuguese escudo	210.332	210.36	210.483	...	209.862	209.809	208.428	209.195	208.257	208.118
Qatar riyal	5.05461	5.05079	5.03947	5.04781	5.05254	5.04981	5.06774	5.09484	5.12334	5.11453
Saudi Arabian riyal	5.20042	5.19649	5.18484	5.19342	5.19826	5.19548	5.2345	5.2418	5.27112	5.26206
Singapore dollar	2.28124	2.27952	...	2.28164	2.28058	2.27658	2.29312	2.2938	2.29667	2.29605
South African rand	4.40821	4.40487	4.40192	4.41752	4.41125	4.41581	4.4343	4.44808	4.46321	4.46748
Spanish peseta	161.748	161.542	161.789	162.057	161.848	161.344	161.172	161.425	160.709	160.63
Sri Lanka rupee	65.5433	65.6325	...	65.5937	65.6552	65.7724	66.3223	66.3726	66.7441	66.7418
Swedish krona	10.7272	10.7535	10.7913	10.8216	10.7325	10.7039	10.8261	10.8783	10.7034	10.6337
Swiss franc	2.09869	2.09455	2.0947	2.10261	2.09181	2.08929	2.08961	2.09294	2.07819	2.09038
Thai baht	35.2157	35.2029	35.1932	35.2514	35.229	35.2099	35.4484	35.4259	35.5678	35.5068
Trinidad and Tobago dollar	5.91643	5.91196	5.89871	5.90946	5.914	5.91081	5.9552	5.96351	5.99687	5.96856
U.A.E. dirham	5.09766	5.09381	5.08239	5.0909	5.09557	5.09282	5.13107	5.13823	5.16897	5.15809
Venezuelan bolivar	117.617	117.667	117.472	117.528	117.36	117.229	118.22	118.413	119.075	119.011

Notes: 1. The value of U.S. dollar in terms of the SDR is the reciprocal of the sum of the dollar values, based on market exchange rates, of specified quantities of the first five currencies shown. The exchange rates used for this purpose are noon rates in the London foreign exchange market. When the London market is closed, noon rates in the New York market are used. Frankfurt fixing rates are used when the New York market is closed. **2.** The value in terms of the SDR of each of the other currencies shown above is derived from that currency's representative exchange rate against the U.S. dollar as reported by the issuing central bank and the SDR value of the U.S. dollar, except for the Iranian rial and the Libyan dinar, the values of which are officially expressed directly in terms of the domestic currency units per SDR.

Data: IMF Treasurer's Department

cent of GDP in 1992 to 13.7 percent in 1995.

In pursuing these objectives, the authorities firmly intend to strengthen financial discipline and to accelerate structural reform. They will place a high priority on the transformation of the economy into an open and free market economy. To this end, distortions in relative prices that result from price and trade restrictions will be removed, and incentives to work and invest will be improved. Greater scope will be generally given to private initiative through an acceleration of the privatization program—including in banking—and a streamlining of regulations governing private sector activity. Other efficiency measures will include a reform in public sector management and increased efforts to provide for and maintain economic infrastructure in support of private sector operations. The authorities also plan to channel additional budgetary resources to investments in human and physical capital. This involves, above all, an increase in budgetary allocations for primary education and health services.

The program for 1993 involves a significant rise in financing requirements owing to costs related to the move toward democratic institutions and the authorities' commitment toward front-loaded action on structural reform. Fiscal developments in 1993 include, notably, the first phase of a reform of the tax and customs systems, which will increase efficiency, improve transparency, and reduce distortions. At the same time, significant measures will be undertaken to improve expenditure control.

Fiscal policy will be supported by prudent monetary management consistent with the balance of payments objective. Interest rates will be kept positive in an effort to stimulate private saving and improve resource allocation. Increased lending to the private sector will be accompanied by a rigorous enforcement of prudential ratios.

The authorities are determined to alleviate poverty through a public works program in urban areas in favor of the most vulnerable groups of the population. Moreover, a program to rehabilitate key social infrastructure will be introduced. Over the long term, the strategy is designed to increase employment generally and to increase the potential growth of output to the benefit of all.

Burkina Faso joined the IMF on May 2, 1963. Its quota under the Ninth General Review is SDR 44.2 million (about $61 million), and its outstanding financial obligations to the IMF currently total the equivalent of SDR 6.32 million (about $9 million).

Press Release No. 93/14, April 1

SELECTED TOPICS

Staff Papers Article Examines Latin America's Capital Inflows

Nearly a decade after the debt crisis erupted, large amounts of capital have begun to flow to Latin America again. Certainly, the economic and political reforms undertaken across the region deserve much credit for this renaissance. But, according to an article in the March issue of *IMF Staff Papers*, important economic developments outside Latin America, notably in the United States, may also be encouraging the capital flows. Two other papers in the journal consider the importance of market discipline in preventing excessive borrowing, and the validity of the monetary model of the exchange rate.

In their paper, "Capital Inflows and Real Exchange Rate Appreciation in Latin America," Guillermo Calvo, Leonardo Leiderman, and Carmen M. Reinhart describe the recent capital flows to Latin America. In the late 1980s, about $8 billion flowed to the region annually; that figure surged to $24 billion in 1990 and to $40 billion in 1991. Changing economic conditions in Latin America deserve partial credit for the recovery: real GDP rose by 3 percent in 1991, fiscal deficits have come down, inflation has dropped markedly, and the region's external debt has been contained.

The authors point out, however, that all Latin American countries appear to be sharing in the boom—regardless of their reform program and performance. They add that domestic reforms by themselves, although important, cannot explain the movement of capital to each country.

External factors may explain the universality of the flows. "Falling interest rates, a continuing recession, and balance of payments developments in the United States have encouraged investors to shift resources to Latin America," explain the authors. In particular, U.S. short-term interest rates are at their lowest point since the 1960s, stimulating the repatriation of capital and increased Latin American borrowing.

The extent to which the capital flows have forced Latin American countries to adjust their policies and their investment goals is extremely important to the future viability of the region's economic recovery. The authors point out that if the capital flows are motivated largely by external developments, these economies become highly vulnerable to a sudden reversal of the flows. An unexpectedly strong recovery in the industrial countries or a price shock—any development that would produce sharply higher interest rates—could turn the tide of capital away from Latin America.

The recent behavior of exchange rates and rates of return reflects the capital inflows. Five of the ten Latin American countries saw appreciation in their currencies before 1991, and all of them, except Brazil, have experienced real exchange rate appreciation since January 1991. The authors conclude that there is "an important degree of co-movement in these variables across countries, despite their wide differences in policies and institutions."

To investigate the role of external developments more rigorously, the

authors first examine the behavior of international reserves and the real exchange rate. They find evidence of parallel movements in these variables across a number of Latin American countries.

Second, the authors establish a strong connection between economic developments in Latin America and the United States. They determine that, in eight of the ten Latin American countries "foreign" (U.S.) factors influence performance, although these factors are generally better at explaining the changes in countries that did not make major adjustments in their domestic policies during 1988–91.

Turning to the policy concerns caused by the flows, the authors note that a major issue facing Latin American policymakers is the health of their export sectors. The real exchange rate appreciation that is associated with capital inflows can erode competitiveness.

A second major concern is the intermediation of capital flows. Proper intermediation can be confounded by speculative "bubbles," lack of policy credibility, improperly priced government insurance, or market failure.

A final concern facing policymakers is the possibility that the capital flows will suddenly reverse, a prospect that can create a domestic financial crisis, exacerbate any improper intermediation, lead to a perception by outside lenders of a negative supply shock, and cause losses on investment projects.

The authors discuss five policies for meeting these concerns: taxing capital imports; changes in trade policy; tightening fiscal policy; sterilized and nonsterilized intervention by the central bank; and insulating the banking system from the capital inflows.

Taxing capital imports might be effective in the short run, according to the authors, but they add that the private sector will ultimately find ways to dodge the taxes.

The authors cautiously support *changes in trade policy* but note that these would entail increases in export subsidies and import tariffs of the same proportion—to avoid distortions between external and internal terms of trade—and an announcement that these subsidies and tariffs will be phased out in the future. Trade policy changes would thus require credible policy commitments and price forecasts.

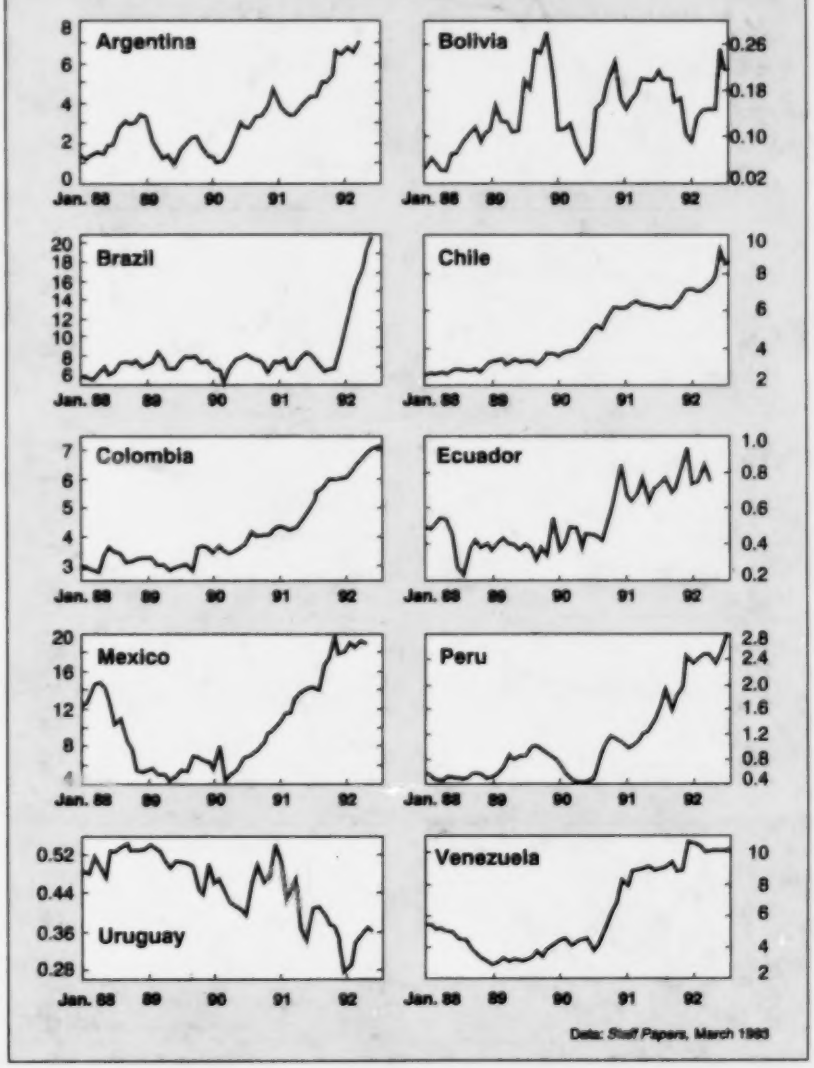
As a means of *tightening fiscal policy*, the authors suggest that expenditure cuts are preferable to tax increases, because widely available credit can interfere with the desired effect of lowering aggregate demand.

With respect to *intervention*, the au-

Most Latin American Countries' Reserves Have Risen

Total Reserves Minus Gold, January 1988 – July 1992

(billion U.S. dollars)



Data: *Staff Papers*, March 1993

thors note that sterilized intervention (the sale of government bonds by the central bank in exchange for foreign currencies and securities) was the most popular policy response in Latin America to the recent rise in capital inflows. Sterilization insulates the stock of domestic money from variations associated with capital flows, which tends to increase domestic interest rates, lower aggregate demand, and mitigate real exchange rate appreciation.

The authors note, however, that one serious drawback of sterilization is its tendency to cause a higher differential between the interest rate on domestic government debt and that on international reserves, thus creating a fiscal deficit. As such, sterilization can perpetuate the capital inflow.

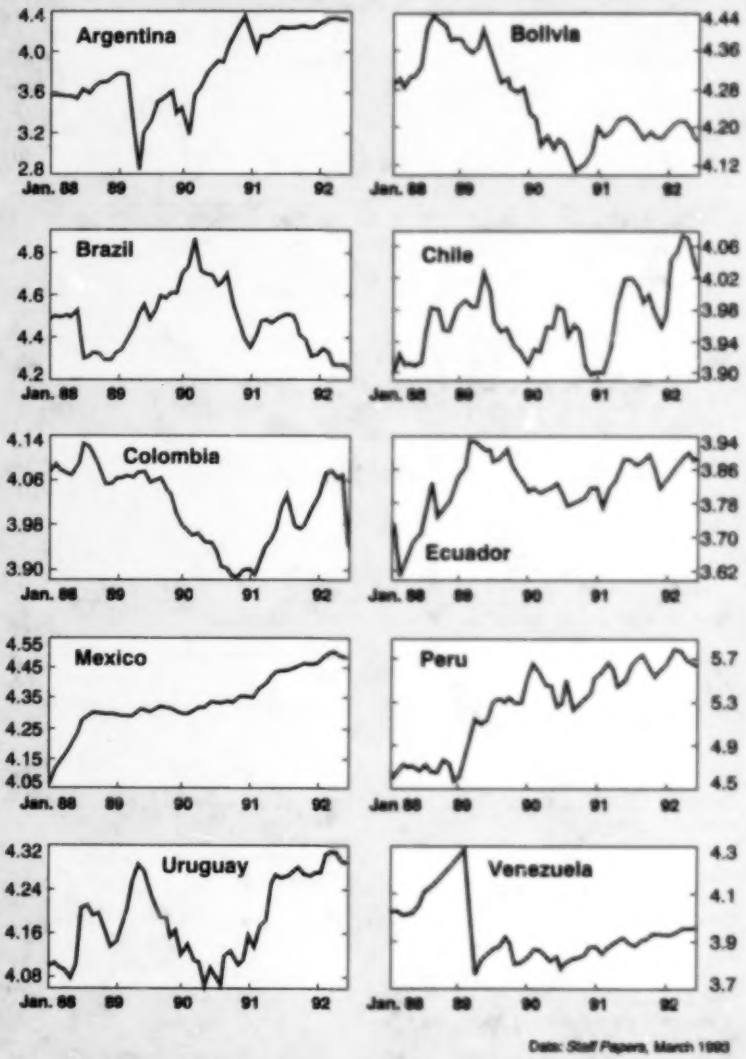
Nonsterilized intervention means the central bank uses domestic currency to purchase foreign exchange. The authors point out that although this policy avoids nominal exchange rate appreciation and a higher domestic-foreign interest rate differential, it can fuel inflationary pressures. Here again, credibility is important in managing the real exchange rate appreciation. A floating-rate regime is more likely to permit a flexible policy response to inflation.

With regard to *insulating the banking system*, the authors suggest that, in cases where a sudden reversal of the capital inflows might threaten the banking system, stricter banking regulations might be appropriate. Sharply higher marginal reserve requirements could result in some disintermediation of the capital inflows and decrease banks' exposure. Regulating banks' investments in the equity and real estate markets could also help insulate them from the effects of a sudden reversal.

The authors conclude that "there are grounds to support a mix of policy intervention based on the imposition of a tax on short-term capital imports, on enhancing the flexibility of exchange rates, and on raising marginal reserve requirements on short-term deposits." They see less of a case for sterilized intervention and caution that, in choosing policy, the authorities should consider the risk of a sudden, large capital outflow.

Nearly All Latin American Countries' Real Exchange Rates Have Appreciated Since 1991

Effective Exchange Rate
January 1988 – July 1992



Data: *Staff Papers*, March 1993

Market Discipline

Timothy D. Lane describes the role of market discipline in preventing unsustainable borrowing. According to him, "market discipline means that fi-

nancial markets provide signals that lead borrowers to behave in a manner consistent with their *solvency*."

The need for effective market discipline is pervasive, Lane suggests. It is necessary at the level of firms—financial intermediaries must lend prudently and firms must borrow in ways that do not undermine their long-term solvency. Market discipline also affects the quality of sovereign lending. The private lending market must be able to discourage sovereign borrowers from pursuing policies inconsistent with solvency. And, at the global level, economic integration and stable economic relations depend on effective market discipline.

Lane points out that market discipline, when effective, works through the lending market. As borrowing increases, the market initially insists on a higher interest rate spread and eventually excludes the borrower from further lending. Effective market discipline requires that capital markets be open, that information on the borrower's existing liabilities be readily available, that no bailout be anticipated, and that the borrower respond to market signals.

Perhaps the most crucial of these conditions, according to Lane, is a credible no-bailout commitment. Bailouts protect lenders from absorbing losses associated with their loans. Indeed, the promise of a bailout can create perverse incentives for lenders: since lenders face little or no risk, they may undertake the riskiest lending possible because it promises the greatest return. Among the myriad forms of bailouts are

- deposit insurance;
- interregional transfers within an economic union (which may constitute an implicit bailout of the high-deficit countries);
- tax deductions for loan write-offs;
- exchange rate management intended to protect a country from its deficit policies;

Lane: market discipline can prevent unsustainable borrowing.

- lending by international financial institutions (IFIs) that allows bank loans to be paid off while the IFI loans are not; and
- the distortion of subsidies and credit policies in formerly planned economies.

Using the case of the prospective European monetary union to examine market discipline, Lane points out that the large fiscal imbalances in the European Community and its small central budget may overwhelm market discipline and require direct policy coordination. On the other hand, the goals of inflation convergence and liberalization of the capital markets may mitigate some of the existing imbalances causing the fiscal deficits.

In a similar case study of sovereign debtors, Lane maintains that several extenuating factors explain the breakdown of market discipline. The external shocks were large; adjustment financing enabled debtor countries to reschedule rather than cancel loans; and deposit insurance, combined with the tax deductibility of loan losses, may have created the perception of an indirect bailout. More recently, however, Lane sees evidence that markets are becoming more effective: they now discriminate among borrowers, and the link between interest rate spreads and sovereign borrowing appears stronger.

Lane concludes that one cannot rely solely on market forces to prevent unsustainable behavior, but to the extent that institutions are designed to work with market forces, discipline is likely to be enhanced.

Exchange Rate Model

In a third paper, Ronald MacDonald and Mark Taylor examine the validity of the monetary model of the exchange rate, focusing on the forward-looking rational expectations on which the model is founded. The basic starting point of the monetary model is its reliance on a relative money-market equilibrium, which links domestic and foreign prices as well as domestic and foreign interest rates.

Using data for the deutsche mark-U.S. dollar exchange rate during 1976–90, the authors draw a number of conclusions. First, because a stable long-run statistical relationship exists that corresponds to the static monetary approach, the model has long-run validity. Second, the monetary model is rejected when it is combined with the assumption of rational expectations, a result that cannot be attributed to speculative bubbles. Finally, and most important, the model can generate forecasts of the exchange rate that are more useful than those generated by forecasting models that assume random variability of exchange rates.

Rozlyn Coleman,
IMF External Relations Department

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EBRD Report Reviews Developments in Eastern Europe and Former U.S.S.R. in 1992

Real GDP declined by about 5 percent in the countries of Central and Eastern Europe in 1992 and by about 20 percent in the states of the former U.S.S.R., according to the European Bank for Reconstruction and Development (EBRD) in its first *Annual Economic Review*. The Review projects that, in 1993, output in Central and Eastern Europe is poised to grow, while that in the former U.S.S.R. will probably decline further.

According to the EBRD, the output losses in Central and Eastern Europe stemmed mainly from the curtailment of domestic producers' access to credit and budgetary subsidies, drops in fixed investment and personal consumption, and a serious region-wide drought. The declines in output undermined earlier official projections for tax revenues and the budget. This was particularly true in Hungary and Poland, where budget deficits widened by 3-5 percentage points of GDP.

Despite the fiscal problems, the main indicators of financial policy looked promising, says the EBRD. Inflation in Central and Eastern Europe fell to about 60 percent in 1992, from about 90 percent in 1991, and the external current account was buoyant in most countries, especially the former Czechoslovakia, Hungary, and Poland. This buoyancy partly reflected a strong improvement in the savings-investment balance of the non-state sector, which more than offset the concurrent deterioration in the state sector's budget balance.

The EBRD suggests that, following the region-wide introduction of "near current account convertibility" and price liberalization in 1991, the most significant structural reform in Central and Eastern Europe in 1992 was the implementation of mass privatization in the former Czechoslovakia. In other countries, large-scale privatization was slower than originally planned, but progress on small-scale privatization was more encouraging.

The economic achievements of the states of the former U.S.S.R. in 1992 were disappointing, according to the EBRD, with most of these states experiencing deep recessions. Investment fell by 40–50 percent, exports declined (in contrast to the countries of Central and Eastern Europe), and imports were sharply cut back because of financing constraints.

The EBRD report points out that inflation within the ruble zone escalated during 1992, under the influence of price liberalization and loose credit policies. The level of consumer prices rose by factors of 23 in Russia and 26 in Ukraine. Prices also rose sharply in other states of the former U.S.S.R.

Fiscal performance varied greatly. Whereas budget deficits were kept at moderate levels in Azerbaijan, the Baltic states, and Turkmenistan, they exceeded 5 percent of GDP in all other states of the former U.S.S.R.

Structural reforms proceeded slowly and unevenly in 1992, according to the EBRD. The major achievements so far have been price liberalization and the allowing of private enterprise. But oligopolistic state enterprises with soft budget constraints are still widely prevalent, and some of the basic institutions needed for a market economy—such as a competitive banking system and regulations governing contracts, bankruptcy, and collateral—are lacking. Although liberal laws on foreign investment have been introduced, the inflow of foreign private capital has been small. Privatization has generally been slow. In Russia, however, small-scale privatization has accelerated since mid-1992, and the "mass privatization program"—which also covers many large enterprises—has gained momentum.

The EBRD projects that short-term prospects for most of the states of the former U.S.S.R. remain bleak: output will decline further in 1993—although probably at a slower pace than in 1992—and recorded unemployment will start to rise. State budgets will come under pressure from a number of sources, including mounting social safety net expenditures and the erosion of the tax base. Moreover, Russia's plans to reduce energy shipments to other states of the former U.S.S.R. and to move the prices of its energy exports closer to world market levels will be costly for the other states. Within the ruble zone, hyperinflation will be a serious threat, and the zone itself may not survive 1993 in its present form.

SDR Rates

Week Beginning	Rate of SDR Interest and Charges (percent)
April 5	5.01
April 12	4.89
April 19	4.86

The rate of SDR interest and charges is calculated weekly, by reference to a combined market interest rate, which is the weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (U.S. dollar, deutsche mark, Japanese yen, French franc, and pound sterling). The interest rates used are those that prevail each Friday. For the latest weekly rates call (202) 623-7171.

Data: IMF Treasurer's Department

Ways to Upgrade Public Expenditure Management Discussed in New IMF Book

As the governments of more and more countries become democratic, increased attention is being focused on their management of public expenditures, according to *Public Expenditure Management*, which was recently published by the IMF.

The book, written by A. Premchand, Assistant Director in the IMF's Fiscal Affairs Department, examines public expenditure management from a variety of perspectives, including those of politicians, administrators, and the public. Drawing on the experiences of both industrial and developing countries, it stresses that a country must have a coherent public expenditure strategy to ensure that appropriate and feasible policies are formulated and then implemented. Premchand comments that "conventional wisdom holds that politics is dominant in policy formulation, and that implementation is administrative in nature. This is a myth, however—for political influence and the interplay of political forces are to be found at every stage of management." Since participants in each stage of the long process of public expenditure management have their own perspectives and values, an overarching stategy is essential; it makes possible the blending of participants' diverse perspectives and values that enables them to work harmoniously together and thereby succeed in managing expenditures effectively.

The book's chapters cover various aspects of this complex subject, including public expenditure management as a composite culture, its institutional aspects, managing fiscal stress, compliance, and public expenditure management in the context of structural adjustment. Also covered are lending programs, guarantees, and quasi-fiscal operations; management aspects of servicing public debt; procurement, contracting out, and expenditure management; and performance measurement and evaluation. Highlights of two of the book's chapters follow.

Public Expenditure Management as a Composite Culture

Premchand notes that governments' fiscal situations in recent years, and particularly during the 1980s, were strongly influenced by two broad trends: (1) a growing disparity between expenditures and revenues, which led to increases in the fiscal deficit that were generally financed in such a way as to exacerbate inflation; and (2) in some countries, economic growth was based on heavy public sector spending financed by means of massive external borrowing. In countries that experienced fiscal crises, these trends—in combination with local influences—undermined their ability to draw on foreign savings (when it became clear to financial markets that they could no longer meet their obligations on external debt) and caused their exchange rates to collapse.

During the 1980s, Premchand asserts, vicious circles prevailed: "Fiscal deficits, large external debts, overregulation, and protectionism appear to have contributed to inflation, exchange rate instability, and higher interest rates, which in turn contributed to macroeconomic uncertainty. Such uncertainty led to low investment or stagnation, which then paved the way to larger fiscal deficits, and so on."

Policymakers consequently sought to create virtuous circles, a key element of which involved strengthening

A. Premchand is the author of **Public Expenditure Management.**

public finances by increasing revenues, containing expenditures, or both. They hoped that this approach, combined with debt reduction and social pacts to moderate the growth rate of wages, would lower inflation and interest rates and raise confidence, investment, and growth rates. Premchand notes, however, that in many instances "public expenditures continued to grow faster than revenues so long as employment in the public sector grew at a faster pace [than in the private sector], wages in the public sector were ahead of the rate of inflation, productivity in the public sector was low, subsidies and associated transfers to the household sector were both routine and open-ended, and interest payments were the highest outlays."

The resulting continuation of fiscal crises convinced many policymakers that structural changes in their economies were necessary. Premchand remarks that "a major element of such structural adjustment was the acceptance that macroeconomic stability would be elusive without a major and

profound correction in public finances in general, and in expenditures in particular." In *Public Expenditure Management*, the author has sought to examine public expenditure management systems, including the interaction between changes in the composition of government expenditure and in related aspects of management.

Public Practice Versus Private Practice. The principles of modern management POSDCORB (planning, organizing, staffing, directing, coordinating, reporting, and budgeting), Premchand observes, apply to both government and private sector organizations. Nonetheless, there are important differences between the two types of organizations. In the public sector, "public scrutiny and the relative openness of decision making" create more constraints than private firms face; consequently, public sector organizations' policy directives "tend to be broad, frequently ill-defined, and contradictory," which necessarily limits public administrators' freedom of action.

Since public sector organizations do not judge the results of their efforts in terms of profit, market share, and economic survival, they often face a conflict between objectives and their feasibility, on the one hand, and the need to be accountable to ministers, politicians, and citizens, on the other. Consequently, the author states, the public sector's "strategic management has been more evident in terms of limits on inputs (manpower, etc.) than in what needs to be accomplished." He notes that until recently economists did not pay much attention to the important differences in the operation of private firms and public sector ones.

Expenditure Management. Premchand notes that expenditure management systems have evolved over the years in response to the increasing responsibilities of governments and the consequent increase in the complexity of their budgets: "In the early stages, the budget was treated as a financial plan that emphasized the mechanisms of payment, accounting, and reporting. Later, the economic implications of the budget were recognized, and the budget itself came to be perceived as a major instrument of economic planning and macroeconomic stabilization and growth. More recently, . . . the budget has come to be viewed, inter alia, as a comprehensive exercise in resource allocation and management with emphasis on relating costs to performance."

"Political influence and the interplay of political forces are to be found at every stage of management."

Current practice in expenditure management recognizes that resource limitations (constraints) affect each stage of governmental decision making, from determining total spending to allocating and managing the component expenditures. Expenditure management is seen as essentially a three-stage process that includes (1) determining policies and objectives, and the kinds and amounts of resources needed to attain the latter; (2) allocating the resources needed to attain specific objectives; and (3) ensuring that necessary tasks are carried out economically, efficiently, and effectively. The author notes that these three stages "correspond to formulating a fiscal plan (thinking process), formulating a budget (operational legal framework), and implementing a budget (doing process)."

Control Framework. Premchand notes the crucial importance of control in expenditure management, which traditionally referred to verifying specific transactions and ascertaining that the expenditures were duly authorized. Later, it encompassed the notion of maintaining constant oversight of government appropriations, eventually being extended to include line-item control of appropriations. The author observes that controls on expenditure management "are processes that enable the specification of objectives, the allocation of resources, and the economic, efficient, and effective utilization of resources while pursuing the objective of stability." He notes that controls need to be implemented with accountability and adds that it is useful to view controls as expressions of power and hierarchical relationships in an organization.

Since the smooth functioning of expenditure management in an organization depends heavily on the nature of control exercised over and within it, Premchand notes, it is important to point out the major criticisms that have been made of structures and systems of control in public sector organizations. First, he comments, "most of the controls and activities of the central and spending agencies seem to operate in a reactive, rather than a proactive, mode, occupied by crisis or other short-term agendas, and with little or no focus on policy or strategy over the medium and long term."

Second, "the structure is dominated by process controls that tend to be deterrent, and they are not matched by positive controls" that provide incentives for compliance with specified norms. Third, the controls exercised have important limitations—for example, some expenditures may be ex-

empted from controls, and efforts to circumvent controls may be tolerated.

Why do some systems of public expenditure management succeed while others fail? Premchand suggests that while the components of any system are important, as is the attention it pays to policy, process, and efficiency controls, management's ability to identify and anticipate problem areas and to evolve policy measures and supporting administrative measures that secure political support is crucial.

Structural Adjustment

During the 1970s and 1980s, developing countries lacked adequate institutional support, particularly in public expenditure management. They thus had difficulty formulating and implementing fiscal policy, and, more generally, undertaking structural adjustment of their economies. As a result, their public expenditure management received more attention from both policymakers and officials of the international financial institutions, including the IMF, making structural adjustment loans.

The more recent efforts of former centrally planned economies to develop and adapt institutions on the basis of market orientation have highlighted the importance of strong public expenditure management. Also, experience gained in international economic cooperation on fiscal policy at the regional level—among members of, for example, the Gulf Cooperation Council (GCC), the European Community (EC), and the West African Monetary Union (WAMU)—has revealed shortcomings in public expenditure management institutions that have hindered efforts to attain common goals.

Although these three cases may seem quite different from one another, Premchand argues, they have many common threads. In all three, structural adjustment efforts emphasize adaptation and rationalization of the public expenditure machinery to different goals. While acknowledging that adjustment is affected by country-specific and situation-specific circumstances, the author explains that he has chosen to concentrate on its more general aspects, such as the overall direction of change, the problems encountered in achieving adjustment, and the ways in which these problems might be avoided.

The transitions of former Soviet states have highlighted the importance of public expenditure management.

Developing Countries' Experience. Soon after attaining independence, developing countries set about reorienting their public expenditure management machinery to facilitate their economic development. For example, they introduced capital or investment budgets and foreign exchange budgets; used investment-appraisal techniques; and introduced program and performance budgeting systems. Premchand comments that these efforts were generally unsuccessful, primarily because "for all the efforts at adaptation, the underlying approaches to expenditure management remained the same."

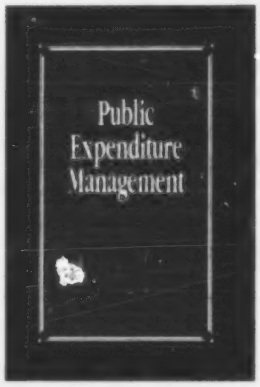
When developing countries reacted to the oil price increases of 1973, many governments "adopted a kind of crisis budgeting whose features were frequent adjustment to resource ceilings, an uncertain budgetary process, ad hoc or across-the-board expenditure reductions, central restrictions on payments, accumulation of arrears, circumventing rules and regulations to accommodate political interests temporarily, and an overall strain on financial managers." Public sector institutions undermined public expenditure management by contributing to rigidities and inefficiencies in the allocation and use of resources, and prevented, rather than facilitated, sustainable growth.

Many developing countries, Premchand opines, consequently aimed at institutional improvement. Once international financial institutions began to emphasize structural adjustment lending, though, institutional reform efforts gained considerable momentum. A review of developing countries' subsequent experience with structural adjustment reveals a mixed picture. Premchand notes that there have been many successful efforts to rationalize extrabudgetary accounts, improve financial reporting and monitoring, and streamline public investment budgets.

Nonetheless, he states, "the general impression both in countries and among international agencies is that fundamental fiscal institutional reform to sustain growth or even to minimize waste and profligacy in government spending has been insignificant." He attributes this outcome primarily to failure to take proper account of the constraints on institutional reform, as well as to strategic considerations, environmental considerations, and the effects of management styles.

Correction: In the third column on page 98 of the previous issue (dated April 5, 1993), the amount of assistance the IMF is providing to 24 low-income countries under its concessional facilities should read "about $3½ billion."

Transition to Market-Based Systems. The author notes that although the centrally planned economies began to discuss their transitions to market-based systems in the early 1980s, they have only recently begun to seriously consider the implications of transition for public expenditure management. He comments that although these countries vary considerably among themselves, his analysis treats them as a generic category in order to focus on steps they can take to facilitate their structural adjustments.



What systemic features are unique to centrally planned economies? First, since they do not acknowledge a financial constraint, this creates a bias in the government toward expenditure. Second, since the development plan is of primary importance, the various government agencies tend to view themselves as being vertically integrated and consequently make little independent effort to monitor and control spending and other aspects of the plan's implementation.

Third, the effect of extended central planning is to reduce the budgetary control of individual agencies by incorporating the budgets of regions, provinces, and other levels of government into the national budget. Fourth, public enterprises tend to be mere appendages of government departments and have little incentive to use resources efficiently or even to avoid running losses.

Premchand cautions that "the transition to the market involves fundamental and not cosmetic changes." The countries of the former Soviet Union, he notes, have been "compelled to build up new institutions of public expenditure management that provide transparency and accountability for transactions in a manner consistent with the objectives of political freedom. . . . They have to be built in a context where fiscal policy itself will be moving from the artificial security of a five-year plan to an economy that is open and at the crossroads of many changes." In addition, a clear delineation of the fiscal tasks and responsibilities of each level of government is essential.

Because their transitions are so comprehensive, Premchand observes, they are bound to strain the administrative capacities of the former centrally planned economies. When inflation is high and balance of payments deficits are unsustainable, macroeconomic stabilization will have to be given priority. Under such circumstances, public expenditure management will need to be adjusted to permit it "to ensure formulation of the appropriate budget (reflecting market orientation and inflation) . . . and . . . sustain implementation of the budget as formulated."

Regional Cooperation on Fiscal Policy. The implementation of regional pacts on fiscal policy necessarily affects the functioning of fiscal institutions and public expenditure management policies in their member countries. *Public Expenditure Management* briefly reviews the experiences of the GCC, the EC, and the WAMU with cooperation on fiscal policy and, in each case, makes several suggestions for making it more effective in the future.

Copies of *Public Expenditure Management* (292 pages, paperbound) are available for US$20.00 each from Publication Services, Box S-369, International Monetary Fund, Washington, D.C. 20431, U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201.)

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International Monetary Fund Launches New Temporary Facility

The IMF's Executive Board has approved the creation of a new facility, called the Systemic Transformation Facility (STF), to help member countries facing balance of payments difficulties arising from severe disruptions of their traditional trade and payments arrangements owing to a shift from significant reliance on trading at nonmarket prices to multilateral, market-based trade. (*See press release on page 136.*)

IMF Managing Director Michel Camdessus unveiled the STF at a press conference on the IMF's relations with the states of the former Soviet Union on April 20 (*see page 130*).

Countries eligible to draw on the STF are expected to include most of those that belonged to the former Council for Mutual Economic Assistance, the states of the former Soviet Union, and a number of other countries experiencing similar transformation.

Camdessus stressed that the STF is designed to be a precursor to a full-fledged arrangement: the IMF would need to be satisfied that any member seeking to draw on the facility will move, as soon as possible, toward policies that could subsequently be supported under an upper credit tranche stand-by, extended, or enhanced structural adjustment facility arrangement.

IMF Managing Director Camdessus: the Systemic Transformation Facility is designed to be a precursor to full-fledged arrangements with the IMF.

Access to the STF will be limited to no more than 50 percent of quota, with financing being provided in two equal disbursements. The rate of charge will be the same as for other uses of the IMF's general resources (currently just under 6 percent a year).

A temporary facility, the STF will be in effect through 1994, although the second disbursement to a country may be completed by the end of 1995, provided that the first is completed by the end of 1994. *(See excerpts from Managing Director's press conference on following page)*

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IMF ACTIVITIES

Camdessus Explains Rationale for New Facility, Supports SDR Allocation

Following are excerpts from a press conference held by IMF Manging Director Michel Camdessus on April 20.

CAMDESSUS: Yesterday, I looked at what I told you one year ago—and possibly you did too. Plenty of things have changed—plenty of developments, a lot of progress, a lot of disappointments. But, we continue with the same commitment and basic confidence that strong and comprehensive stabilization and reform policies can do much for the transformation [of the countries of the former Soviet Union], and we can do much to support them.

Last year, someone asked, "how much money will you spend [in the former Soviet Union] over the next four or five years?" I answered $25 billion to $30 billion. This morning I want to reconfirm that figure.

We still believe that if these countries persevere steadfastly with excellent programs and if we are able to put in place a ruble stabilization fund, among other things, we will extend to them the maximum possible support. But we cannot do that alone, and support from other multilateral and bilateral sources will be critical, particularly the support of the World Bank and the newly established EBRD [European Bank for Reconstruction and Development].

Support from other sources will be critical, particularly the support of the World Bank and the EBRD.

Now, how can I tell you today that we will continue with this ambitious program after all that we have learned about the difficulties of the transition, and after all of the well-known institutional problems, the slow pace of reform, the chaotic developments in the former Soviet Union?

Of course, it is difficult, and it is for us a totally unprecedented challenge, one which I am really proud to see this institution accept and respond to.

I would like, today, to give you a clearer perception of what we are doing in this regard. But, first, one should not indulge in excessive pessimism. The first responsibility we have is to look at the reality of the situation. If you take these 15 countries of the former Soviet Union, you will see that they are pictures of contrast.

Progress in the Former Soviet Union

I am quite excited by the admirable progress that we are seeing in several of these countries, particularly those facing perhaps the most severe challenges. The Baltic countries come particularly to mind. It is remarkable that these countries have decided to confront head-on the sharp drop in living standards that is inevitable at the time of transition. They have faced very courageously and very creatively the dissolution of trading and monetary arrangements with their former partners of the former Soviet Union. They have suffered [a sudden rise in the import price of energy to world levels and] a tremendous loss in their exports, amounting to about 30 percent of their GNP. Despite this, they have continued implementing and broadening a very ambitious program for stabilization and reform.

We have a good chance next month to adopt a similar program with Kyrgyzstan. We are quite advanced in similar negotiations with Kazakhstan and are working in the same spirit and with the same ambition in Belarus. You know well that the state of war and the political instability in the sub-Caucasian countries have made it difficult for them to concentrate on economic reform. But we are looking forward to the earliest possible opportunity to facilitate this kind of action for these countries too.

The IMF and Russia

But, where is the Fund with respect to Russia? Well, the progress has been uneven, globally insufficient, but progress has been accomplished. You remember the strong start under the leadership of Acting Prime Minister Gaidar, which allowed us to propose around the time of the Munich summit a three-step strategy: first, a credit tranche drawing, then a stand-by arrangement, and then activation of the stabilization fund. This is still our strategy. Of course, the implementation of this strategy has been put on hold because of the institutional crisis and the consequent difficulties the

Russian Government has had implementing such a strategy. But, this crisis has not at all interrupted our cooperation with them. We have continued with our technical assistance to Russia. And we have continued with the policy dialogue.

The technical assistance has enormously improved our own knowledge of what is needed. I would like to give you an idea of the effort that is being expended. I would like to give you some figures, for the first time [in response to] the criticism that we have not been sufficiently present in the former Soviet Union. In fiscal year 1993, we will devote—and all of that is launched already—about 45 percent of our technical assistance to the countries of the former Soviet Union. The Fund is an institution of 2,300 staff. In 1993, we will have 828 staff visit the former U.S.S.R. countries. It does not mean that 828 staff will go there, because several of them will go several times, but you see the effort.

Camdessus with reporters at the conclusion of the press conference.

So, we have not lost time; together we have made, I think, enormous progress in preparing for action. But nevertheless, this standstill has had very negative repercussions, one of them being the human suffering caused by the prolongation of the transition. Another threat is hyperinflation. Nothing is worse for young democracies than hyperinflation. The suffering of the poorest in the society is also a concern. With this loss of momentum in the transformation effort, the systemic element of the crisis cannot but exacerbate the situation for those who have not started or have barely started the stabilization and reform effort.

So, at the beginning of this year we were confronted with a difficult dilemma. The first credit tranche operation was half completed, and a stand-by arrangement was not imminent because of the institutional crisis, even though the program announced by [Russia's Deputy Prime Minister and Finance Minister] Fyodorov has all the potential of allowing a major step in the right direction, provided it is steadily and comprehensively implemented.

What should we do in such a situation? Should we wait until they are ready to start a new, full-fledged program, or should we try to invent something more relevant to the situation and pave the way to a regular arrangement? We hesitated, but we came to the conclusion that as long as we are not alone, as long as the rest of the world joins us in a very innovative and bold new approach, then in view of the quality of the policies the Government of Russia wants to implement, it was good to try to help them address the immediate problems created for their balance of payments by the systemic disruptions. This is why the staff has helped me to develop a new instrument whose purpose is exactly that. Recognizing that the countries want to go to full-fledged IMF programs but need more time to prepare the institutional basis for them, let us see what we can do in the meantime to help them address the consequences of the collapse of the trade and payment arrangements within the former CMEA [Council for Mutual Economic Assistance].

The Systemic Transformation Facility

Last Friday, our Executive Board adopted the key elements of the Systemic Transformation Facility. I am in a position today to describe this instrument in good detail, as well as the strategy in which it is embedded. I would like to briefly start by giving you my answers to three or four questions most likely of concern to you. When will the new facility be available? What will it finance? Who will be the beneficiaries? And will there be any conditions? Will it be, "send us a letter and we will send you the check"? Or something else? I will try to answer these four main questions.

First, the facility will be a temporary facility. It will cover the period from now to the end of 1994, because we believe that the systemic crisis will reach its peak during this period. This amount of time will be needed by many of the countries to avail themselves of all the instruments needed to effectively implement a program with the Fund.

Second, and this is where there is a sense of particular urgency, this new instrument is designed to be a precursor to the full-fledged arrangements we are aiming at. The struc-

ture of the facility, its conditionality in particular, is designed to prepare for that. To be eligible for this facility, a country will have to demonstrate its full commitment to cooperating with us toward a goal of full-fledged arrangements. We are paving the way, establishing a kind of ramp, toward full-fledged, traditional stand-by arrangements, like those that have been successful in Poland, Estonai, Latvia, and other parts of the world.

Third, what will we be financing? Basically, the members' balance of payments needs. This is what we do in the Fund—finance balance of payments needs—in this case those arising from severe disruptions in traditional trade and payment arrangements, which are manifested in three ways.

One is a sharp fall in export receipts due to a shift from trading at nonmarket prices, such as those prevailing in the former CMEA or within the states of the former Soviet Union. Another is a substantial and permanent increase in net import costs due to the fact that the goods they bought from traditional partners are now sold at market prices or prices have moved in that direction. Here, of course, energy prices come immediately to mind. You can also have a combination of one and two. These are the balance of payments problems we will try to address.

Countries will have to demonstrate that they will cooperate in solving their balance of payments problems.

Fourth, the beneficiaries of this facility will certainly be the countries of the former Soviet Union and country members of the former CMEA, as well as a few other countries that had similar trade and payment situations and are experiencing similar transformation difficulties. This facility will not be a free lunch. Checks will not be distributed just like that. This is a precursor facility. Countries will have to demonstrate that they will cooperate in solving their balance of payments problems and that they will move as soon as possible toward policies that the IMF could subsequently support through stand-by, EFF [extended Fund facility], or ESAF [enhanced structural adjustment facility] arrangements. It will not be enough to send a nice letter saying, "We will do it." We will need significant policy actions as first steps in this process, including, when appropriate, prior actions. Indeed, as hyperinflation is the real threat to reform, we will give great emphasis to monetary policy and to all financial policies designed to stop and reverse capital flight. We will strongly encourage the adoption of, or the intention to adopt with our support, all institutional or structural reforms needed to create the framework for a true market economy. We will also be careful to have these countries renounce any tightening of their exchange or trade restrictions, the introduction of further restrictions, and multiple currency practices. Further, they will have to agree to cooperate with their trading partners in seeking constructive solutions to their common problems.

Let me add that, on the issue of access, we will allow a country to borrow up to 50 percent of its quota. It will be disbursed in two tranches of equal size. Normally, the second one will be disbursed six months after the first, unless the country enters into a full-fledged traditional arrangement before the end of the six months. Then we would complement the arrangement with the second tranche under this facility.

In view of the extreme seriousness of the problems of these countries, we have decided to lengthen the repayment period for this facility. It will be quite like our ESAF or our extended Fund facility, repayable in ten years with a four-and-a-half-year grace period.

It is important to note that it is with the unanimous support of the Executive Board of the Fund that we have launched this facility, which required at least an 85 percent majority in our Executive Board. But I think this unanimous support goes beyond the adoption of the facility itself. It shows the full commitment of the institution and its membership to support this transformation.

In announcing this effort, I expect that this will not be the last word of the IMF in this respect. In particular, I look forward to the support of the membership for my recommendation of a new SDR allocation, which would fit particularly well with the need to avoid undue reserve constraints on the imports of these countries at a time when the entire world so needs a sharp growth in imports from all possible quarters.

But, this is a different story to which I will certainly return next Tuesday. But, now, I will take your questions.

QUESTION: How would you respond to those who are saying that in a slightly different way the conditions of this facility are as tough and unrealistic as those imposed on, or rather tied to, the agreement [with Russia] last year?

CAMDESSUS: The conditions of last year were not unrealistic, because no institution can pretend to be more realistic than the country itself about what a country wants to do. Last year, the program we agreed upon with Mr. Gaidar was not a program imposed on Russia by the IMF. This was a program Mr. Gaidar, with the full support of President Yeltsin, wanted to implement. All we did, working with him in full trust as we now do with the new authorities, was to help him to establish the macroeconomic framework

needed for the coordination of all these measures. This program was not more unrealistic than the programs that are now succeeding in smaller countries like Latvia or Estonia, or that have had significant success in Poland, for instance. It was less ambitious than that, in fact. It turned out that due to internal reasons—basically related to the institutional crisis and the unwillingness of the central bank to fulfill what it had pledged—this program has been only half implemented. But this is not a reason to see the program as unrealistic.

The IMF panel at the press conference comprised (from left): John Odling-Smee, Jack Boorman, Managing Director Camdessus, Shailendra Anjaria and Hernan Puentes.

Now, you are right that the conditions of this facility are slightly different because they emphasize, in view of its temporary character, its role as a precursor. The facility will try in particular to make sure that all the structural, institutional, and instrumental elements needed for a successful program are put in place during this preparatory period.

But, simultaneously, we have to make sure that the country works toward a program and addresses without delay the problems that can destroy transformation and democracy. Here I refer to hyperinflation. We could not spend the money of the IMF's membership in a country where nothing credible is being done to address capital flight. Why should we, who have a global membership, put money into a country when the next day this money would be in accounts in Lausanne, Zurich, Miami, and Paris—I should not forget the French banking system—and in many other places, except Russia? No, this problem has to be addressed. Call them unrealistic conditions if you want. But for us it is the only way to lend effectively and in accordance with our Articles, which require that we lend only with appropriate safeguards. After almost 50 years of existence, this institution knows very well that there is no better safeguard for our lending activities than good programs. We need, even if it is in a precursory way, to establish proper conditions for this new instrument.

QUESTION: Could you to go into a little bit more detail on the gauge for this new facility's success? Are you going to dictate inflation or deficit levels? The 10 percent or single-digit inflation on a monthly basis, is that still a target? Could you also give examples of countries other than the former Soviet Union that might be candidates for the new facility?

CAMDESSUS: We never dictate. The countries come with their own programs. We are there to evaluate whether these programs can achieve what they claim. And if there are elements within the program that are inconsistent or insufficient for achieving the program, we try to get an agreement with the country on what is needed for the program to succeed. This is the so-called dialogue on conditionality. No more than that.

Of course, the context here is a specific country, if I can refer to Russia, where a program has already been announced by the Minister of Finance, Mr. Fyodorov. This program is ambitious but, to our judgment, has reasonable targets for inflation reduction and budget deficit reduction, and we will discuss with the Russian authorities the sequencing of measures needed to achieve this result. Within this package of measures, we will certainly try to convince them to take, at the very beginning of the program, those steps that are particularly indispensable for stopping hyperinflation and stopping capital flight. A significant number of the measures, particularly in the monetary field, will be necessary at the very beginning of the program, possibly even before signing the program. I understand that the Russian authorities look on that very favorably, because they know better than we that this is indispensable.

What other countries could be possible candidates for the facility? Among Eastern European countries, you have Bulgaria, Hungary, Poland, and Romania. They are still suffering the shock of disruption and are eligible for this support.

QUESTION: You said outside the former CMEA.

CAMDESSUS: Possibly in Asia, for instance. Countries of the former Indochina. You could have Mongolia. We will look at them case by case and see if the shock is of such a magnitude that a country can justify this support.

QUESTION: Sir, you mentioned the magic word SDR, and I was wondering how this fits in with this proposal. There have been reports that the SDR [allocation] is only for the former Soviet Union countries. Also tied with that is what you consider a kind of general allocation for everybody, and how does that fit in? Secondly, how much money will be disbursed under this new facility—the total amount in quantitative terms?

CAMDESSUS: I will take your second question first.

You see there is a broad membership of potential candidates. We will have to analyze, within this group, which countries are severely affected. Then we will [support them with] up to 50 percent of their quota. Assume, for instance, that all the states of the former Soviet Union will be candidates for it, and I think not all will be—you have, for instance, those who are energy exporters and with no true balance of payments need. Their total IMF quota is $9 billion, so 50 percent of it will be $4.5 billion. So, [disbursements] will be somewhere between $4 billion and $6 billion over the next 18 months with the possibility of some late disbursements beginning in 1995, depending on the timing of the requests.

Now, is an SDR allocation relevant to the problem of these countries? Are there grounds for an SDR allocation now in the membership? My answer is yes, with a personal conviction I try to have shared by the membership. Why? Because to allocate SDRs you need to demonstrate that there is a long-term global need for reserve supplementation. And this need is there. At present, 40 percent of our membership has reserves amounting to less than ten weeks of imports.

"Are there grounds for an SDR allocation now in the membership? My answer is yes . . . ."

Second, for the small, low-income countries, the situation is one of true catastrophe. On average, developing countries have a ratio of reserves to imports of goods and services of 33 percent, or one third, but small, low-income economies have a ratio of 13 percent or 14 percent. And the former Soviet Union countries had a ratio of 10.8 percent in 1992. So, we have a situation that obliges these countries to severely constrain their imports and then slow down their transformation efforts in order to accumulate reserves.

Moreover, I believe that, particularly at a time when inflation is at a historic low, and when the world needs an immense effort to speed up recovery, the case for the SDR allocation is very strong. It would allow us to correct a factor that for me is embarrassing—the fact that 37 of our members, particularly the countries of the former Soviet Union, have never been allocated SDRs, while other members of the IMF have allocated to themselves, in much less pressing circumstances, a significant amount. So I think an allocation would help us to correct some of this imbalance.

I encourage the membership to consider voluntary schemes for a redistribution of SDRs, particularly the SDRs that would be allocated to industrial countries that do not need them. Then you would have extraordinarily positive leverage to help industrial countries do more, not only for Russia but for all countries where the problem of external financing comes with a severe acuity. The rest of the world will have to be ready to help Belarus, to help Ukraine, the entire list. You see how difficult it has been to assemble a package for Russia. Resources will be needed. I think an SDR allocation is in order.

QUESTION: Mr. Managing Director, you said several times now that this new program, like all other IMF programs, will have to be seen in the context of balance of payments financing for the countries. Now, after the Tokyo meeting of the Group of 7 countries, we have been entertained with this figure of roughly $43 billion that needs to be found by the international community to, what I would term, finance the Russian balance of payments gap. Are you prepared to say that this is a figure that the IMF supports, that Russia does have a balance of payments gap, within the next 12 to 18 months, of $43 billion that needs to be supported, and that [the IMF is going to help finance]? That would be the first part of the question.

And the second part of the question is, knowing full well that gaps of that magnitude, $20 or $30 billion, do not disappear within 12 months, what will you bring us next year in terms of new IMF means to finance the gaps that will prevail then?

CAMDESSUS: Thank you for these questions. Two or three points.

What I can tell you is that the $40 billion, more or less, is a good order of magnitude, in my judgment, of the financing requirements of Russia this year. I believe that this will have to be met through debt rescheduling, from both official and private contributions, and from the IMF. The Group of 7 has given figures of possible access under an IMF stand-by arrangement, and I look forward to being able to do that. They have also noted the stabilization fund.

Will we be able in 1993 to activate a stabilization fund under the GAB [General Arrangements to Borrow]? I don't know. It will depend heavily on the readiness of the Government to adopt very strong monetary measures and the backing the Government will have for a strong and comprehensive action during the second part of the year. You will have in Russia the disbursements by the World Bank and by the EBRD, which is extremely active in the domain of small and medium-size enterprises. Yes, something of this magnitude will be needed and hopefully disbursed.

As a matter of fact, what was done last year was more or less this. I am a bit shocked when I read that under the so-called $24 billion program last year, nothing was disbursed.

This is incredible to me. We know here at the IMF, as we look at the figures, that more than the $24 billion was put in place. I could give you the details of that. But, this is the past.

For the future, you are absolutely right. When a country has financial requirements on the order of $40 billion, the needs will still be there the following year—hopefully far less but still significant. Not only the following year, but several years after. The central element of our strategy is that at the very beginning of the process support must come from multilateral sources. But, as time passes the bilateral effort must become significant, and the private sector must get involved. I do believe that at the end of the process you will have nothing from multilateral sources and a very strong flow of resources from private agents, non-debt-creating flows from the private sector.

QUESTION: When do you think this new facility will be available for these countries? And are any African countries eligible for this new facility?

CAMDESSUS: When? Well, very soon. I hope that the Executive Board will adopt the facility next Friday [April 23]. After that, implementation should follow immediately. There is a sense of urgency, in that it will pave the way to something else. Indeed, I very well expect that one or several countries will draw the first installment under this facility within a month or two.

Now, African countries as potential candidates for this facility: this is possible. We have to look at their balance of payments situations, as several of them have been closely connected with the former CMEA system, and one could imagine that they will draw under this facility. However, almost all African countries can be financed under our ESAF facility, which costs less, as you know. I would imagine that they would prefer to avail themselves of ESAF financing. But we, management and staff, will make sure that the size of the support they get under ESAF takes due consideration of the kind of support we are considering under this facility.

QUESTION: Mr. Camdessus, this new program seems to be both idealistic and pragmatic. Now, on the pragmatic side, can it be that you have preferred to have a brand new program with its own rules and parameters so that you do not have to dilute conditionalities for other countries?

CAMDESSUS: I prefer that you dwell on pragmatism rather than idealism! But, on the pragmatism of it, you are absolutely right. We wanted to be able to be straightforward and not embarrassed by the specific instrumentalities and constraints of all the instruments available—for instance, the so-called CCFF [compensatory and contingency financing facility]. We have to avail ourselves of instruments that fit the problems we face.

You remember that the IMF has done that several times in the past. When we had the Middle East crisis we created a special window under the CCFF. At the time of the oil shocks, in the 1970s, my predecessor, Mr. Witteveen, created two special facilities to deal with them. Here we have created a new facility that would not be hindered by artificial constraints. I would like to tell you—and possibly this is the idealistic aspect of it—that I see merits in having the full endorsement of the membership for this action. To create a new instrument and then to ask the entire membership to vote on it is of great value. And this is what we will have done.

From the Executive Board. . .

Costa Rica: Stand-By Credit. The IMF has approved a stand-by credit for Costa Rica, authorizing drawings of up to the equivalent of SDR 21.04 million (about $30 million) over the next ten months to support the Government's macroeconomic program for 1993.

Since mid-1990, Costa Rica has been implementing an economic and financial program, supported by the IMF, to reduce imbalances in the economy and increase growth prospects through greater reliance on market forces. Preliminary data for 1992 indicate that real GDP increased by more than 7 percent owing to a resurgence in private consumption and strong growth of private investment; unemployment was reduced; inflation declined to 17 percent from 25 percent in 1991; and there was a larger-than-expected increase in Costa Rica's net international reserves.

Costa Rica's program for 1993, which the current stand-by credit supports, aims at achieving GDP growth of about 4 percent, further reducing inflation, and increasing net international reserves. To meet these aims, the combined public sector deficit will be reduced to 1 percent of GDP in 1993, from 1.5 percent in 1992, and credit expansion will be restrained. Structural reforms under the program include measures to broaden the tax base and shift some public sector activities to the private sector, the privatization of two of the three remaining state-owned manufacturing companies, further price liberalization, and reductions in import tariffs.

The program also expands the scope of the Government's social safety net with financing from the Inter-American Development Bank and bilateral donors. Programs are envisaged to assist the unemployed, along with labor training schemes for new employment opportunities. Additionally, a child care program has been initiated to complement the housing and food voucher programs in operation since 1990.

Costa Rica is an original member of the IMF, and its quota is SDR 119 million (about $168 million). Its outstanding financial obligations to the IMF arising from past operations and transactions currently total SDR 59 million (about $83 million).

Press Release No. 93/15, April 19

Succession of the Former Yugoslav Republic of Macedonia. The Executive Board of the IMF determined today that the former Yugoslav Republic of Macedonia has fulfilled the necessary conditions to succeed to the membership of the former Socialist Federal Republic of Yugoslavia (SFRY) in the IMF. On December 14, 1992, the IMF determined that the SFRY had ceased to exist, and therefore ceased to be a member of the IMF. At the same time, the IMF decided that the Republic of Bosnia and Herzegovina, the Republic of Croatia, the former Yugoslav Republic of Macedonia, the Republic of Slovenia, and the Federal Republic of Yugoslavia (Serbia/Montenegro) are the successors to the assets and liabilities of the SFRY in the IMF and, subject to specified conditions, may succeed to its membership in the IMF (see Press Release No. 92/92).

The former Yugoslav Republic of Macedonia's quota in the IMF is SDR 33.5 million (about $47 million). The quota may be increased to SDR 49.6 million (about $70 million) on payment of a subscription equivalent to SDR 16.1 million (about $23 million), of which 25 percent is payable in SDRs or in currencies acceptable to the IMF.

With the succession of the former Yugoslav Republic of Macedonia, effective December 14, 1992, IMF membership now totals 176 countries.

Press Release No. 93/16, April 21

Systemic Transformation Facility. The IMF has approved the Systemic Transformation Facility (STF), a temporary facility to provide financial assistance to member countries facing balance of payments difficulties arising from severe disruptions of their traditional trade and payments arrangements owing to a shift from significant reliance on trading at nonmarket prices—such as prevailed among members of the former Council for Mutual Economic Assistance (CMEA) and among the states of the former Soviet Union—to multilateral, market-based trade.

The systemic transformation from state trading toward multilateral, market-based trade and integration into the international financial and trading systems has confronted the affected countries with severe adjustment problems. Many of these countries have suffered sharp drops in exports as well as permanent increases in import costs, particularly for energy products, because of the shift to market prices. The disruption of pre-existing payments arrangements and associated credit relationships has compounded these trade shocks, as has a lack of access to alternative sources of external financial assistance. Moreover, many of these members face the task of developing basic institutional capabilities of economic management to replace central planning, and are thus ill prepared to adjust in an orderly manner.

The new Systemic Transformation Facility will better enable the IMF to help facilitate this historic transition for many of its members. The success of this effort is critical to the well-being of the entire international community. The main features of the STF are described below.

Purpose

The new facility is designed to provide assistance to members severely affected by these systemic changes that are willing to cooperate in an effort to find appropriate solutions to their balance of payments problems—including countries at an early stage of the transition process and as yet unable to formulate a program that could be supported by the IMF under its existing facilities and policies. Members that use the new facility will also need substantial additional financial support from other sources over a sustained period.

Eligibility

The facility will be open to members experiencing balance of payments difficulties arising from severe disruptions in their traditional trade and payments arrangements as manifested by (1) a sharp fall in export receipts owing to a shift from significant reliance on trading at nonmarket prices to multilateral, market-based trade; (2) a substantial and permanent increase in net import costs owing to a shift from significant reliance on trading at nonmarket prices toward world market pricing, particularly for energy products; or (3) a combination of the two. Eligible members include most former CMEA members and countries of the former Soviet Union, as well as a number of other countries that are not so immediately involved in the transformation process but that are being affected significantly by it as a result of their earlier substantial nonmarket trading ties to the former CMEA.

Members that have or have already had IMF arrangements would normally be expected to use the new facility in the context of their existing or future arrangements. When appropriate, this could result in an increase in their overall access to IMF resources.

Qualifications

For a country requesting financing under the new facility, outside of an upper credit tranche or an ESAF [enhanced structural adjustment facility] arrangement, the IMF will need to be satisfied that the member will cooperate in solving its balance of payments problems and, specifically, that it will move as soon as possible toward policies that could be supported under an upper credit tranche stand-by, extended, or ESAF arrangement. Significant policy actions designed as first steps in this process will be expected, including prior actions. Progress toward stabilizing the economy, stemming capital flight, and implementing structural and institutional reforms needed to create a market economy and to conduct economic policy in a market framework will be emphasized. In particular, convincing actions to stabilize monetary conditions will be a precondition for those member countries where inflation has been unacceptably high or is accelerating.

The request for financing will be accompanied by a written policy statement describing the objectives of economic policy; macroeconomic projections; structural, fiscal, monetary and exchange rate measures to be implemented over the period covered by the STF; and, if applicable, a technical assistance program. The member will be required to put in place a quantified quarterly financial program as soon as feasible, and in any event before its second purchase under the facility. The member will be expected to agree not to tighten exchange or trade restrictions or

introduce new restrictions or multiple currency practices, and will also agree to cooperate with its trading partners in seeking constructive solutions to common problems.

For countries making use of the new facility in the context of existing or future upper credit tranche stand-by, extended, or ESAF arrangements, the approval of such an arrangement, or the completion of a review, would satisfy the conditionality requirements of the STF.

Access and Terms

Access will be limited to not more than 50 percent of quota. Access to the new facility will depend on a balance of payments need stemming from the disruptions of a member's traditional trade and payments arrangements and could be in addition to any financing obtained under other IMF facilities. Disbursements under the facility will be made from the IMF's General Resources Account; the rate of charge will be the same as for other uses of the IMF's general resources (currently just below 6 percent a year); repayment terms of four and a half to ten years will be the same as IMF financing under the extended Fund facility.

Phasing

Financing will be provided in two disbursements: half of the total financing will be disbursed at the outset. The remainder would normally be disbursed in about 6 months, but no later than 12 months, after the first purchase, depending on continued cooperation and policy implementation; satisfactory progress toward agreement on an upper credit tranche stand-by, extended, or ESAF arrangement; articulation of a quantified financial program—where one was not already in place; and progress in mobilizing financing from other sources. In some cases the second disbursement could take place in less than six months, depending on policy implementation; and it could take place after two months in cases where the member reached agreement on a new upper credit tranche stand-by, extended, or ESAF arrangement or a review was completed under an existing arrangement.

Temporary Nature

The facility will be temporary in nature, and will be in effect through 1994. However, the second drawing may be completed by the end of 1995, provided that the first disbursement is made by the end of 1994.

There are precedents for the creation of temporary financing facilities in the IMF. In December 1990 the compensatory and contingency financing facility (CCFF) was modified to include a temporary petroleum import financing component in the context of the Middle East crisis. Earlier, in 1974 and 1975, the IMF had created two oil facilities to deal with temporary financing problems related to sharp oil price increases among oil importing developing countries.

Press Release No. 93/17, April 23

Stand-By, Extended, Structural Adjustment Facility (SAF), and Enhanced Structural Adjustment Facility (ESAF) Arrangements as of March 31, 1993

(million SDRs)

Member	Date of Arrangement	Expiration Date	Amount Agreed	Undrawn Balance
Stand-by arrangements			**4,824.10**	**2,568.71**
Albania	August 26, 1992	August 25, 1993	20.00	10.31
Barbados	February 7, 1992	May 31, 1993	23.80	9.22
Brazil	January 29, 1992	August 31, 1993	1,500.00	1,372.50
Bulgaria	April 17, 1992	April 16, 1993	155.00	31.00
Czech Republic	March 17, 1993	March 16, 1994	177.00	107.00
Egypt	May 17, 1991	May 31, 1993	234.40	87.20
Estonia	September 16, 1992	September 15, 1993	27.90	15.11
Guatemala	December 18, 1992	March 17, 1994	54.00	54.00
India	October 31, 1991	June 30, 1993	1,656.00	231.00
Jordan	February 26,1992	August 25, 1993	44.40	11.10
Latvia	September 14, 1992	September 13, 1993	54.90	29.74
Lithuania	October 21, 1992	September 20, 1993	56.93	39.68
Panama	February 24, 1992	December 23, 1993	93.68	58.83
Poland	March 8, 1993	March 7, 1994	476.00	476.00
Uruguay	July 1, 1992	June 30, 1993	50.00	34.03
Extended arrangements			**8,568.58**	**2,763.97**
Argentina	March 31, 1992	March 30, 1995	2,483.15	1,182.16
Hungary	February 20, 1991	February 19, 1994	1,114.00	556.77
Jamaica	December 11, 1992	December 10, 1995	109.13	100.13
Mexico	May 26, 1989	May 25, 1993	3,729.60	466.20
Peru	March 18, 1993	March 17, 1996	1,018.10	375.41
Zimbabwe	September 11, 1992	September 10, 1995	114.60	83.30
SAF arrangements			**83.23**	**59.45**
Comoros	June 21, 1991	June 20, 1994	3.15	2.25
Ethiopia	October 28, 1992	October 27, 1995	49.42	35.30
Rwanda	April 24, 1991	April 23, 1994	30.66	21.90
ESAF arrangements			**2,091.29**	**780.95**
Bangladesh	August 10, 1990	September 13, 1993	345.00	–
Benin	January 25, 1993	January 24, 1996	46.95	39.12
Bolivia	July 27, 1988	September 10, 1993	183.26	13.61
Burkina Faso	March 31, 1993	March 30, 1996	48.62	48.62
Burundi	November 13, 1991	November 12, 1994	42.70	23.49
Equatorial Guinea	February 3, 1993	February 2, 1996	12.88	10.12
Guinea	November 6, 1991	November 5, 1994	57.90	40.53
Guyana	July 13, 1990	December 20, 1993	81.52	8.86
Honduras	July 24, 1992	July 23, 1995	40.68	33.90
Lesotho	May 22, 1991	May 21, 1994	18.12	7.55
Malawi	July 15, 1988	May 31, 1993	66.96	5.58
Mali	August 28, 1992	August 27, 1995	60.96	50.80
Mauritania	December 9, 1992	December 8, 1994	33.90	25.43
Mozambique	June 1, 1990	September 30, 1993	100.65	15.25
Nepal	October 5, 1992	October 4, 1995	33.57	27.98
Sri Lanka	September 13, 1991	September 12, 1994	336.00	168.00
Tanzania	July 29, 1991	July 28, 1994	181.90	96.30
Uganda	April 17, 1989	November 24, 1993	219.12	19.92
Zimbabwe	September 11, 1992	September 10, 1995	200.80	145.90
TOTAL			**15,567.20**	**6,171.08**

Note: Figures may not add to totals because of rounding. Data: IMF Treasurer's Department

SELECTED TOPICS

Effects of High Real Interest Rates Under Financial Liberalization Explored in Study

Despite a widespread belief to the contrary, the high and positive real interest rates (that is, interest rates net of inflation) frequently observed after countries undertake financial liberalization are not necessarily harmful to their economies, according to a recent IMF working paper.

"High Interest Rates Under Financial Liberalization: Is There a Problem?" was written by Vicente Galbis, Advisor in the IMF's Policy Development and Review Department. It explains that, beginning in the 1980s, concern began to mount among policymakers and economists because of "evidence that, under some conditions, financial liberalization could be associated with excessively high real interest rates that could choke an already indebted corporate sector, sending a wave of bankruptcies throughout this sector and, in turn, throughout the financial sector, leading thereby to an economic crisis." Further, developing countries were viewed as more likely than developed countries to become unstable when undergoing financial liberalization because of, among other things, their narrower financial markets; lack of effective, market-based monetary policy instruments; and difficulties in adequately supervising their financial systems.

The Record

The Galbis paper focuses on the experiences of 28 countries—26 developing countries and 2 developed countries (the United States and Spain)—with financial liberalization, including transition to a system of market-based interest rates. It notes that financial liberalization encompasses domestic policies designed to spur competition in financial markets, limit reserve liquidity and portfolio requirements on financial institutions "to what is necessary for the proper conduct of monetary policy and regulation," and eliminate the offering of credit by the central bank or official banks at below-market interest rates.

Galbis stresses that "financial liberalization needs to be accompanied by stronger prudential regulation and supervision of financial institutions, increased market information, and better enforcement of consumer protection regulations." He adds that liberalization also encompasses policies that provide for the dismantling of capital controls and the opening up of domestic markets to foreign financial institutions. Further, Galbis cautions that "it is . . . important to see financial liberalization in the broader context of macroeconomic adjustment and structural reforms."

The study's sample is split evenly between countries that achieved full interest rate freedom and those that moved in this direction but "retained a degree of interest rate control within a liberal framework." Of the former 14 countries, 7 changed relatively quickly from financial repression (direct control of markets by the government) to full interest rate freedom: Argentina, Bolivia, Chile, Hungary, Poland, Romania, and Uruguay. Of these country cases, perhaps those of the Southern Cone countries—Chile, Argentina, and Uruguay—have been examined most frequently in economic literature and have generated the greatest controversy.

The other seven countries in the former group—Brazil, Spain, the United States, Jamaica, Mauritius, Mexico, and the Philippines—made less dramatic transitions to full interest rate freedom. In some cases, such as that of Brazil, their transitions simply involved formal recognition of the situation that prevailed before liberalization began. Both Spain and the United States moved slowly and "in a programmed fashion" toward full financial liberalization.

The latter group of 14 countries included 3 francophone African countries—Benin, Cameroon, and Côte d'Ivoire; Colombia; Costa Rica; Korea; Malaysia; Nepal; Nigeria; Tanzania; Thailand; Turkey; and Venezuela.

Galbis opines that "it is not possible in general to characterize interest rates as being high or low except in relation to the particular circumstances of the country under discussion." He notes that the main relevant circumstances are the rate of inflation and the relationship of domestic interest rates to foreign interest rates. For purposes of his paper, he defines interest rates as high if the underlying real interest rates—those obtained by netting out inflation, as measured by the country's consumer price index—are positive by at least 3 percentage points.

The data Galbis presents show that

in most of the 28 countries in the sample, the liberalization of interest rates "allowed the rates to increase toward positive real levels" and, further, that real interest rates increased in 14 of the 16 countries for which reliable data were available for the periods before and after liberalization.

Possible Causes of High Real Interest Rates

The study observes that the most frequently cited causes of high real interest rates in financial markets are (1) the persistence of high inflationary expectations following an attempt by the authorities to achieve price stabilization; (2) the risk of rapid exchange rate depreciation; (3) the implementation of the wrong mix of macroeconomic policies, especially fiscal expansion accompanied by monetary restraint; (4) the oligopolistic [with oligopoly a situation in which a few sellers face many buyers in a market] behavior of financial institutions; (5) distress borrowing—borrowing by firms already in financial difficulties—by nonfinancial enterprises; and (6) the risks (moral hazard) resulting from the existence of explicit or implicit deposit insurance not accompanied by adequate bank supervision.

It also notes that high real interest rates can be caused by very strong demand for investment funds—owing, for example, to the introduction of new technologies, new opportunities opened up by regulatory changes, and reduced real wages in the economy. Under such circumstances, high real interest rates would be a sign of a healthy economy and efficient financial markets rather than indicating that policymakers needed to take corrective action. Galbis also points out that "a combination of various causes and circumstances would be more likely to lead to high real rates than any single factor" and that "temporary and unpredictable shocks" can also affect the behavior of interest rates.

Likely Effects

Galbis expresses the view that "the association between high real interest rates and . . . [their] presumed effects is largely country-specific and does not lend itself to easy generalizations." For example, although high real interest rates are usually presumed to decrease a country's rate of investment, this may not always be the case. In an effort to discern patterns in the relationship among countries' real interest rates, investment, and economic growth, the study calculated long-term averages for 20 countries in the sample for which the relevant data were available. One of the conclusions that emerges from the resulting figures is that the increase in real interest rates that generally resulted, at least in part, from the liberalization of interest rates was usually followed by an increase in the rate of economic growth and a decrease in investment. This pattern suggests that "there was an increase in productivity after the liberalization of interest rates that more than offset the decline in the investment rates."

Vicente Galbis, Advisor in the IMF's Policy Development and Review Department, is the study's author.

Corporate and Financial Sector Distress. High real interest rates may, indeed, discourage investment in a country. Nonetheless, Galbis observes, high real rates may increase the efficiency of investment "if lending for investment is allocated on the basis of high real returns on capital to enterprises which may be able to repay the loans." At the same time, he points out that distress borrowing by nonfinancial enterprises and investment by unsound enterprises may proceed despite high real rates, leading in both cases to eventual defaults. Galbis cautions that "the effects of high real interest rates in creating or aggravating a corporate and financial sector crisis will depend on the phase of the business cycle, but even more importantly on the general trends of such other prices that affect the financial conditions of enterprises as the real exchange rate and the real cost of labor."

Capital Inflows. Galbis points out that while the movement of interest rates toward positive real levels following liberalization can lead to a surge of capital inflows that, in turn, makes it hard for the national authorities to maintain control of the money supply and to keep inflation in check, this is not a foregone conclusion. He notes that the actual result "could be significantly affected . . . by the [country's] previous history of capital flows, by whether capital controls had been effective or not before the liberalization, and by current inflationary expectations and perceptions of exchange rate risk."

The sample data indicate that capital inflows have tended to increase following interest rate liberalization. The author points out, however, that "there is strong evidence of extremely large, probably destabilizing capital inflows only in the cases of Chile (1980–81), Jamaica (1984-85), and Uruguay (1979–80)."

Government Debt. In a system with market-determined interest rates, the emergence of high real interest rates will tend to worsen public finances by raising the cost of servicing public debt. The study notes that the actual impact of such a development will depend primarily on (1) the size of the public debt at the time high real interest rates emerge, and (2) the extent of the rise in interest rates.

It also points out that some developing countries that continue—even after liberalization—to finance their public debts by means of forced borrowing at concessional interest rates from the central bank or from the banking system may use this mechanism to stabilize their public debts temporarily, thus buying time in which to apply revenue and expenditure measures to close their budget gaps. If they persist in borrowing through nonmarket channels, however, they will make it harder for the monetary authorities to control the money supply, leading to increased inflation and fostering inflationary expectations. In some countries that move to interest rate freedom from an environment of financial repression, however, the real value of the public debt may be so seriously eroded by the previous inflation and low interest rates that debt-service costs do not loom large.

Suggested Remedies

When a country plans to move to interest rate liberalization, it is best advised to take preventive measures to avoid the adverse effects that may result from the emergence of high real interest rates rather than taking remedial measures after the fact. Nevertheless, a country that is undergoing liberalization may find itself facing positive and rising real interest rates and consequently need to take remedial measures. "In this case," Galbis comments, "the precise identification of the causes of the problem and the use of the correct instruments to deal with them will be the most efficient way to prevent high real interest rates." He adds that if adequate remedial measures cannot be taken immediately, the authorities can sometimes buy time by using "last-resort mechanisms (preferably moral suasion and voluntary [credit] restraints)" to restore orderly market conditions before implementing a more permanent, market-oriented solution.

Galbis notes that an economy's initial macroeconomic and structural conditions will strongly influence the effect that financial liberalization has on interest rates, as will the sequence by which interest rates are freed within the country's overall stabilization and liberalization effort. He acknowledges that while the measures required for remedying a problem of high real interest rates are not, in principle, different from those needed to prevent it, the former task will generally be more difficult to accomplish than the latter.

Conclusions

The Galbis study concludes that the first thing a country needs to do when it experiences high real interest rates is to determine whether it, in fact, has a problem. If its high real rates indicate that it is experiencing an investment boom and rapid economic growth, it need not take any action. If, however, high interest rates are creating problems for the functioning of the financial system and the economy, the authorities need to examine the circumstances carefully and act to eliminate the causes of these problems.

The undesirable causes of high real interest rates, the study notes, can be grouped into macroeconomic causes, on the one hand, and those relating to the structure and functioning of the financial sector, on the other. Among the most frequently cited macroeconomic causes are unabating inflationary expectations, perceptions of exchange rate risk accompanying stabilization efforts that are not judged to be fully credible, and attempts to stabilize the economy by relying on tight monetary policy accompanied by inadequate fiscal discipline. These causes can be exacerbated by the inability of the country's monetary authorities to influence market interest rates because of the lack of market-based policy instruments and insufficient development of the financial markets in which such instruments can be used.

Among the most frequently cited structural causes are excessive efforts by oligopolistic financial institutions to increase their market shares by attracting more deposits, lending to distressed nonfinancial firms that is undertaken to enable financial institutions to avoid provisioning and write-offs for loan losses, and the risks (moral hazard) created by providing deposit insurance without adequate bank regulation and supervision.

Galbis emphasizes that high real interest rates can have multiple and complex causes. Consequently, "it will be necessary to understand the causes and the consequences of high real interest rates in the particular setting of each country before any remedies are applied, if and when necessary." He warns that caution is always called for when a country is considering either direct or indirect market intervention to address a perceived problem of high real interest rates, because it is often difficult for the country to determine whether it is facing a transitory or a more permanent problem.

A limited number of copies of "High Real Interest Rates Under Financial Liberalization: Is There a Problem?," which is No. 93/7 in the IMF's Working Paper series, are available free of charge from Publication Services, International Monetary Fund, Washington, DC 20431, U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201.)

Origins of Poland's Output Decline Examined at IMF Seminar

After Poland embarked on a "shock therapy" reform of its economy in 1990, the country experienced a sharp decline in its industrial output. That decline has been arrested, if not reversed, in recent months, but its causes remain a subject of much debate. Did structural adjustment, which is commonly associated with temporary declines in output, precipitate this downturn or were macroeconomic policies the key factors?

Eduardo Borensztein and Jonathan Ostry, Senior Economist and Economist, respectively, in the IMF's Research Department, examined Poland's output decline in 1990 and 1991 to identify its source. Their findings formed the basis of an April 8 seminar at the IMF Visitors' Center entitled "Determinants of the Output Decline in Poland and Related Issues." The seminar, which also drew the participation of Jacek Tomorowicz of the Polish Embassy in the United States, was chaired by Liam Ebrill, Chief of the Central European Division of the IMF's European I Department.

Background

Some of the early estimations of the impact of shock therapy—or the "big bang" approach to economic reform—theorized that the transition could be accomplished without a significant drop in output, Ebrill recalled. Some Western academicians were initially convinced that centrally planned economies, which appeared so rife with inefficiencies, were unlikely to experience any further decline in output. "Of course," observed Ebrill, "in every single country in Central Europe, this turned out not to be the case."

In the face of widespread, significant, and persistent output declines throughout Central Europe, however, the consensus shifted quickly: output declines came to be perceived as not only inevitable but perhaps long term. But then reality again overtook the-

Ebrill : output declines came to be perceived as both inevitable and long term.

ory, Ebrill noted, and data, notably for Poland, indicated a pickup in industrial sales. "We are only just now," he said, "arriving at what might be an overall view of the process."

Nature of the Decline

Why, asked Ostry, would the origins of Poland's output decline be of concern? "If most of the decline in output in 1990–91 reflects macroeconomic forces rather than structural change," he noted, "that tells us something about the duration of the recession and the future path of output. Ultimately the effects of structural change will have an additional impact on output."

In designing their study, Borensztein and Ostry classified the causes of Poland's output decline into two broad categories: structural and macroeconomic. Under structural change, the researchers hoped to gauge the degree to which productive resources had been reallocated. A new price structure, occasioned by large-scale trade and price liberalization and substantial increases in administered prices, should prompt a shift of resources from less productive to more productive fields.

Over the short run, market economies undergoing such a shift would probably record a transitory reduction in aggregate output, as resources moved from sectors where relative prices and profitability had fallen to those sectors that had been less adversely affected. Economies in transition are likely to face additional complications, since greater uncertainty would presumably inhibit employment and investment from expanding, even in the less affected sectors.

Under the macroeconomic heading, the authors subsume two sets of forces. On the demand side, a constellation of very tight fiscal, monetary, and incomes policies was designed to reduce aggregate demand and help reduce and stabilize inflation. On the supply side, it was argued that substantial increases in administered energy prices coupled with relatively tight credit ceilings might cause some firms to face a credit crunch, which in turn would lead to reduced aggregate supply.

Official GDP figures indicate that Poland suffered a 20 percent decline in output over 1990–91 before recording a marginally positive rate for 1992. Ostry observed that Poland's experience needs to be placed in a regional perspective; neighboring countries that delayed reforms also experienced large output declines. It was difficult to determine, he said, how much of Poland's precipitous decline in output could be attributed to the reform package and how much to a region-wide recession.

Poland's official GDP figures, which did not fully record the impressive growth that took place within the private sector, tended to overstate output declines. However, by any measure, Poland's industrial output did decline, with significant intersectoral variations. In some sectors, output dropped by more than 50 percent; others, however, recorded relatively little decline. In the food sector, output actually recorded a small increase.

Methodology

For the purposes of their study, Borensztein and Ostry attributed to macroeconomic factors anything that could not be attributed to resource reallocation. But identifying resource reallocation empirically is a very difficult task, Borensztein said. In a normal business cycle in a mature market economy, some industries do very poorly in a recession, while others flourish. Their study attempted to correct for these "normal" cyclical differences.

The study also sought a benchmark against which to judge Poland's output decline. Following a method employed by Stockman (*Journal of Monetary Economics*), Borensztein and Ostry took a cross section of Central European countries with similar economic distortions (such as low pre-reform energy prices) and used disaggregated industrial data to determine whether industrial shocks (such as technological change) or national (macroeconomic) policies explained the larger fraction of output changes. For this group of countries, the authors found that macroeconomic policies accounted for most of the output change; moreover, industry-specific shocks proved statistically insignificant.

If the decline reflects macroeconomic forces, it tells us something about the future path of output.

A second test sought to determine whether variations in output and employment could be accounted for by a small number of common factors relative to the case of some benchmark country, taken here to be the United States. The study found some evidence of resource reallocation in production, but less so in employment, where there was more evidence of an across-the-board change in Polish employment than would be typical in a market economy such as the United States.

A third test concerned the question of whether resources had moved to sectors with higher international comparative advantage. For this test, Borensztein and Ostry employed a methodology developed by Hughes and Hare in the United Kingdom and De La Calle in the World Bank.

Their research found no pattern to indicate a shift of resources away from sectors in which Poland appeared to display a lower international comparative advantage. Borensztein cautioned, however, that the imprecision in the measures of comparative advantage could be partially responsible for this result.

Results of the Study

The authors cautioned that their study covered only 1990–91 and included only the industrial sector, which was dominated by state-owned enterprises. Given these caveats, however, the authors did find that, to date (and their research is ongoing), there was very little statistically significant evidence of resource reallocation in Poland.

Several members of the audience expressed concern about certain aspects of the study's methodology, notably its decision to concentrate on intersectoral resource shifts. Borensztein noted that because the study was set up to capture changes in resource allocation across sectors, it had indeed been unable to capture reallocations within sectors.

There was, in fact, anecdotal evidence to suggest that such intrasectoral resource shifts and changes of product were taking place. Likewise, the concentration on the industrial sector, still dominated by state-owned enterprises, understated the role of Poland's dynamic private sector in resource real-

SDR Rates

Week Beginning	Rate of SDR Interest and Charges (percent)
April 26	4.81
May 3	4.75

The rate of SDR interest and charges is calculated weekly, by reference to a combined market interest rate, which is the weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (U.S. dollar, deutsche mark, Japanese yen, French franc, and pound sterling). The interest rates used are those that prevail each Friday. For the latest weekly rates call (202) 623-7171.

Data: IMF Treasurer's Department

location. Borensztein noted, however, that intersectoral reallocations should eventually be an important component of the structural reform process in Poland.

A Polish View

Tomorowicz, Minister Counselor for Trade and Commercial Affairs at the Embassy of Poland in Washington and previously Director of the Polish planning ministry, offered the seminar's concluding presentation. He focused on recent trends in Poland, particularly on the signs of an apparent recovery in industrial production. He cited development of entrepreneurial skills, a dramatic expansion of the private sector (from 5 percent of total output in 1989 to 30 percent in 1992), improved business information and banking services, the beginnings of adjustment in large state enterprises, a 10 percent growth in labor productivity, and improvements in domestic production in the face of competition from imported goods as critical factors in the improvement of Poland's industrial output.

Structural change, Tomorowicz ventured, would probably play a role in stimulating further output increases in the near future. Greater privatization, improved banking and financial systems, and modernization of the technological infrastructure all raised the potential for widened business opportunities. Although he did not expect the demand side to have a positive role in Poland's economic performance this year, Tomorowicz, citing the country's good relationships

Currency Units per SDR

APRIL

Currency	6	7	8	9	12	13	14	15	16	19
Deutsche mark	2.25085	2.25749	2.266	...	...	2.24653	2.24088	2.25523	2.26164	2.27669
French franc	7.62886	7.64344	7.66469	7.6543	...	7.58727	7.57814	7.62453	7.64772	7.682
Japanese yen	159.773	159.907	159.4	159.769	159.543	159.145	160.295	160.565	159.292	156.488
Pound sterling	0.92548	0.923332	0.924337	...	...	0.910158	0.906467	0.911731	0.91545	0.922041
U.S. dollar	1.40275	1.40208	1.40379	1.40704	1.41251	1.41211	1.41291	1.40908	1.40842	1.4098
Argentine peso	1.40065	1.39998	...	...	1.4111	1.4114	1.4122	...	...	...
Australian dollar	1.99737	1.98539	1.97912	...	...	1.97913	1.96921	1.95678	1.9646	1.96817
Austrian schilling	15.8385	15.8715	15.9569	...	...	15.7987	15.7723	15.8634	15.9236	16.0153
Bahrain dinar	0.527434	0.527182	0.527825	0.529047	0.531104	0.530953	0.531254	0.529814	0.529566	0.530085
Bangladesh taka	54.7073	54.6811	54.7478	54.8746	55.0879	55.0723	55.1035	54.9541	54.9284	54.9822
Belgian franc	46.3654	46.4299	46.7216	...	...	46.3313	46.0856	46.3975	46.5553	46.8265
Brazilian cruzeiro	36623.4	37085.6	...	...	37855.	38348.4	38883.7	39302.3	39815.9	40395.
Canadian dollar	1.7662	1.76802	1.76597	...	1.78005	1.78095	1.78451	1.77657	1.77292	1.77071
Colombian peso	1176.58	1176.65	...	...	1186.03	1186.4	1187.72	1185.11	1185.17	1186.88
Danish krone	8.65777	8.66275	...	...	...	8.64564	8.58625	8.64893	8.69066	8.73019
Finnish markka	8.17366	8.16768	8.15237	...	...	8.06315	7.84094	7.83547	9.24994	7.85865
Greek drachma	306.95	307.869	308.974	308.719	308.64	306.569	306.036	307.447	...	...
Indian rupee	43.7939	43.801	43.8404	43.9419	44.1127	44.1849	44.21	44.2451	44.1681	44.1549
Indonesian rupiah	2902.29	2900.9	2905.85	2912.57	2923.9	2921.66	2923.31	2918.2	2916.84	2919.7
Iranian rial	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3	...
Iraqi dinar	0.436055	0.435847	0.436378	0.437389	0.439089	0.438965	0.439213	0.438023	0.437818	0.438247
Irish pound	0.924139	0.925465	0.927206	...	...	0.917729	0.91813	0.924229	0.927141	0.932469
Italian lira	2235.7	2231.3	2201.87	2206.97	...	2174.37	2164.04	2177.1	2164.9	2164.
Korean won	1116.03	1116.76	1117.7	1120.	1124.06	1123.9	1124.25	1121.35	1120.96	1121.78
Kuwaiti dinar	0.422803	0.422601	0.423116	...	0.425448	0.424875	0.425116	0.424415	...	0.424632
Libyan dinar	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286
Malaysian ringgit	3.62891	3.61737	3.62206	3.62918	3.64357	3.64155	3.64955	3.64318	3.63936	3.63757
Maltese lira	0.524471	0.523829	0.526731	...	0.525097	0.523527	0.520332	0.52353	0.523868	0.526221
Nepalese rupee	69.8008	69.7535	69.8386	70.0002	69.9616	69.8712	69.9108	69.7213	69.6886	69.7569
Netherlands guilder	2.53126	2.53734	2.54619	...	...	2.52146	2.51879	2.53324	2.54248	2.55498
New Zealand dollar	2.63625	2.62071	2.60782	...	...	2.61502	2.60925	2.60699	2.61205	2.6151
Norwegian krone	9.59902	9.61196	...	...	...	9.57058	9.5103	9.5592	9.58852	9.6388
Omani rial	0.539357	0.5391	0.539757	0.541007	0.54311	0.542956	0.543264	0.541791	0.541537	0.542068
Pakistan rupee	37.4769	37.459	37.5046	37.5915	37.7376	37.7977	37.8191	37.7166	37.6989	37.7358
Portuguese escudo	208.48	209.606	210.804	...	...	208.899	208.05	209.213	209.836	210.617
Qatar riyal	5.10601	5.10357	5.1098	5.12163	5.14154	5.14008	5.14299	5.12905	5.12665	5.13167
Saudi Arabian riyal	5.2533	5.25079	5.25719	5.26936	5.28985	5.28835	5.29135	5.277	5.27453	5.2797
Singapore dollar	2.27863	2.27894	2.28326	...	2.2942	2.29157	2.29457	2.29455	2.29375	2.2867
South African rand	...	4.47614	4.46405	...	...	4.46227	4.46974	4.47876	4.49636	4.48246
Spanish peseta	161.316	161.786	...	...	...	161.87	161.453	162.692	163.588	164.199
Sri Lanka rupee	...	66.8091	67.031	...	67.518	...	...	67.354	67.6042	67.6704
Swedish krona	10.7149	10.7247	10.7425	...	...	10.6233	10.4089	10.5026	10.5462	10.5601
Swiss franc	2.0793	2.08391	2.08856	...	...	2.06521	2.05225	2.06219	2.06559	2.06552
Thai baht	...	35.052	35.4878	35.5559	...	...	...	35.5793	35.5626	35.5552
Trinidad and Tobago dollar	5.97659	5.97374	5.98102	5.99487	6.01818	6.01647	6.01986	6.00356	6.00075	6.00663
U.A.E. dirham	5.1495	5.14704	5.15331	5.16524	5.18532	5.18386	5.18679	5.17273	5.17031	5.17538
Venezuelan bolivar	118.953	118.866	...	...	119.922	119.888	120.097	119.913	119.927	...

Notes: 1. The value of U.S. dollar in terms of the SDR is the reciprocal of the sum of the dollar values, based on market exchange rates, of specified quantities of the first five currencies shown. The exchange rates used for this purpose are noon rates in the London foreign exchange market. When the London market is closed, noon rates in the New York market are used. Frankfurt fixing rates are used when the New York market is closed. 2. The value in terms of the SDR of each of the other currencies shown above is derived from that currency's representative exchange rate against the U.S. dollar as reported by the issuing central bank and the SDR value of the U.S. dollar, except for the Iranian rial and the Libyan dinar, the values of which are officially expressed directly in terms of the domestic currency units per SDR.

Data: IMF Treasurer's Department

with its neighbors, increasing inflows of capital, and growing investor confidence foresaw strong prospects for recovery in the near future.

Tomorowicz cautioned, however, that a difficult financial situation and growing technological obsolescence still posed significant dangers for state-owned enterprises. The problems state enterprises face in this transition period particularly concerned him. He suggested that a certain level of effective protection needed to be extended to state enterprises to help them deal with foreign competition. He also noted that managerial training and the early development of financial instruments and know-how might facilitate cooperation between banks and the state enterprises.

Borensztein (left) and Ostry: to date there is little statistical evidence of resource reallocation in Poland.

Lessons

Borensztein and Ostry stressed that their research was intended to analyze the nature of the output decline rather than provide a critique of the Polish adjustment process. They were willing, however, to draw several broad lessons from their work.

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Ostry cited the importance of moving rapidly to establish better incentives for managers of state enterprises to respond to relative price signals. For example, he believed that improving corporate governance in the state enterprise sector and moving rapidly toward the commercialization and privatization of these enterprises would send the right signals to managers to enable them to respond to large price and profitability changes. Poland, he added, had moved relatively more slowly on those aspects of structural reform than it had on stabilization.

Ebrill added that, while the research confined itself to examining the nature of output decline in the very early stages of one country's economic transition, the findings suggest a possible pattern of response, and perhaps some important lessons, for countries that may be further behind in the reform process.

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